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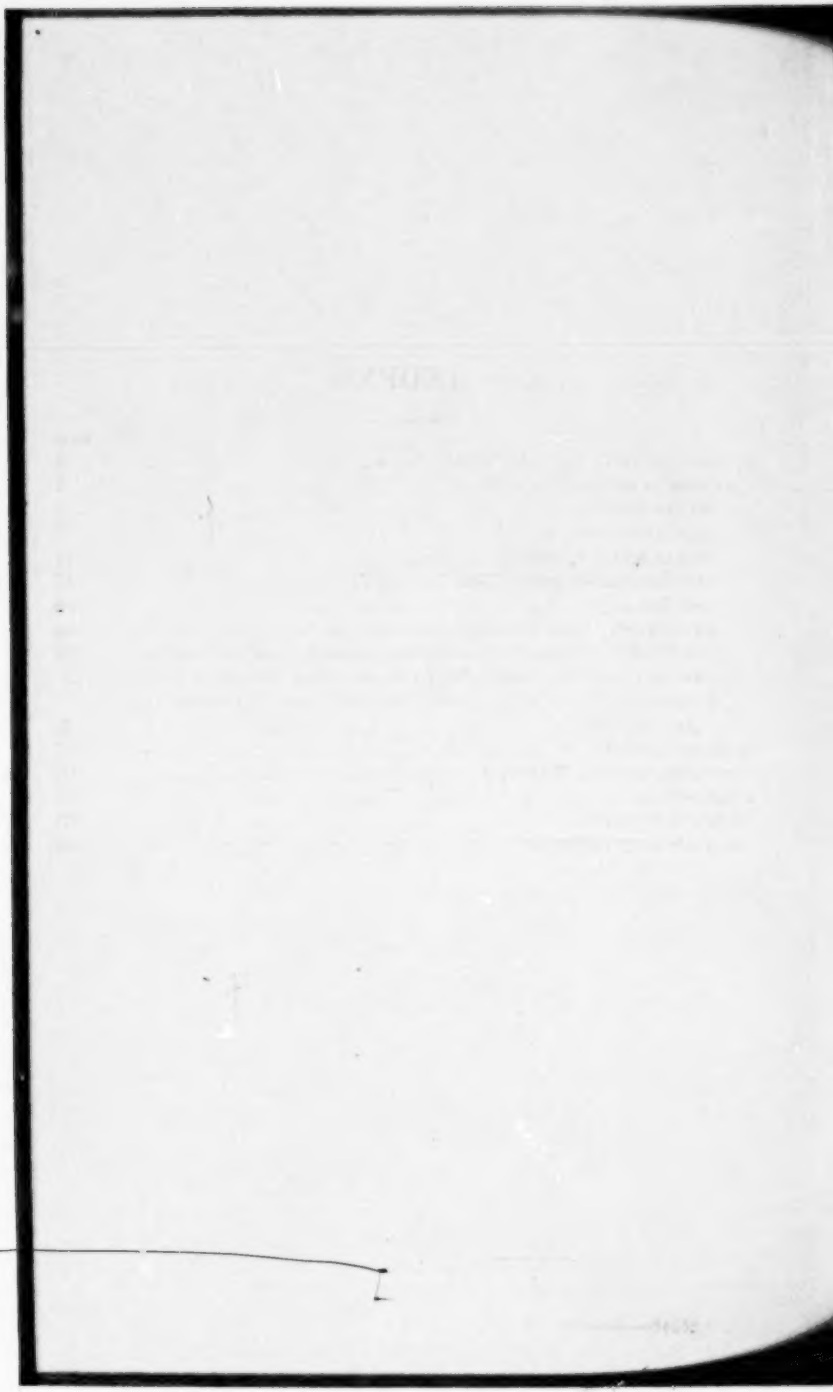

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APPENDIX TO THE PETITIONER'S BRIEF

Docket Entries

Docket No. 9893

Philadelphia Transportation Company, petitioner

v.

Commissioner of Internal Revenue, respondent

Appearances: For petitioner—William R. Spofford, Esq., Frederic L. Ballard, Esq., Chester J. McGuire, Esq., Sherwin T. McDowell, Esq. For respondent: Brooks Fullerton, Esq.

DOCKET ENTRIES

1945

Dec. 27—Petition received and filed. Taxpayer notified. Fee paid.

Dec. 27—Request for hearing at Philadelphia, filed by taxpayer. 1/9/46 Granted.

1946

Jan. 2—Copy of petition served on General Counsel.

Feb. 27—Answer filed by General Counsel.

Mar. 5—Copy of answer served on taxpayer—Philadelphia, Pennsylvania.

1947

Jan. 20—Hearing set March 17, 1947—Philadelphia, Pennsylvania.

Mar. 17—Hearing had before Judge Harlan on merits. Motion to file amendment to petition—Granted; Motion and amendment to petition; answer to amendment to petition and appearance of Sherwin T. McDowell as counsel filed. Stipulation of facts and supplemental stipulation of facts also filed at hearing. Copy of motion and amendment served. Petitioner's brief due 4/16/47. Respondent's brief 5/16/47. Respondent's reply brief 6/5/47.

Apr. 1—Transcript of hearing 3/17/47 filed.

Apr. 16—Brief filed by taxpayer. 4/16/47 Copy served.

1947

May 7—Motion for extension to 6/16/47 to file brief, brief lodged, filed by General Counsel. 5/8/47 Granted.

July 11—Motion for extension to file the attached brief, brief lodged, filed by General Counsel. 7/15/47 Granted.

Aug. 5—Motion for extension to 8/20/47 to file reply brief, filed by taxpayer. 8/7/47 Granted.

Aug. 20—Reply brief filed by taxpayer. Copy served.

Nov. 28—Findings of fact and opinion rendered, Judge Harlan. Decision will be entered under Rule 50. 12/3/47 Copy served.

1948

Feb. 17—Respondent's computation for entry of decision filed. Agreed to.

Feb. 19—Decision entered. Judge Harlan. Div. 11.

May 17—Petition for review by U. S. Circuit Court of Appeals, 3rd Circuit, filed by General Counsel.

May 17—Notice of filing petition for review sent to W. R. Spofford, filed.

May 19—Proof of service of petition for review on W. R. Spofford filed.

May 20—Proof of service of petition for review on taxpayer filed.

June 9—Motion for extension to 8/13/48 for the parties to file their stipulation re record, filed by General Counsel.

July 9—Order enlarging time to 8/13/48 to prepare and transmit record, entered.

Aug. 5—Motion to retain exhibits in Clerk's office until ten days prior to hearing in the U. S. Circuit Court of Appeals, 3rd Circuit, filed by General Counsel. 8/6/48 Motion Granted.

Aug. 5—Stipulation re record on review filed.

The Tax Court of the United States

Docket No. 9893

PHILADELPHIA TRANSPORTATION COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

STIPULATION OF FACTS

It is hereby stipulated with respect to the above-entitled proceeding that the following statements may be accepted as facts and that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence at the trial of this case not inconsistent with the facts herein stipulated.

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1. Philadelphia Transportation Company (hereinafter referred to as petitioner) is a corporation organized under the laws of the Commonwealth of Pennsylvania, with its office and principal place of business at 1405 Locust Street, Philadelphia, Pennsylvania.

2. Petitioner keeps its books of accounts and files its tax returns on the accrual basis of accounting.

3. Petitioner's consolidated Federal income and Declared Value Excess Profits Tax Return for the calendar year 1942 was filed with the Collector of Internal Revenue for the First Collection District of Pennsylvania at Philadelphia, Pennsylvania, on June 15, 1943, pursuant to an extension to June 15, 1943, of time for filing duly granted by respondent on May 7, 1943. Photostatic copy of the petitioner's consolidated Federal Income and Declared Value Excess Profits Tax Return for the calendar year 1942 is submitted herewith, made a part hereof and marked Exhibit 1-A.

4. In its consolidated Federal Income and Declared Value Excess Profits Tax Return for the calendar year 1942 petitioner reported taxable net income (i. e. "normal tax net income") in the amount of $1,780,269.13 and liability for income tax in the amount of $747,517.96 which was paid. Respondent, in his Notice of Deficiency, mailed to petitioner on October 8, 1945 (Exhibit A of the petition) determined an income tax deficiency against petitioner in the amount of $834,982.38.

5. On October 23, 1945, petitioner paid to the Collector of Internal Revenue, Philadelphia, Pennsylvania, $925,052.05 of which $800,000 was in partial payment of the deficiency determined by respondent and $125,052.05 was interest on such $800,000 from March 15, 1943, to October 23, 1945. A transcript from the Collector's records evidencing the payments on account of income tax for 1942 is submitted herewith, made a part hereof and marked Exhibit 2–B.

6. On October 1, 1934, Philadelphia Rapid Transit Company, a corporation organized under the laws of the Commonwealth of Pennsylvania, filed in the District Court of the United States for the Eastern District of Pennsylvania, a petition under Section 77B of the Bankruptcy Act. Philadelphia Rapid Transit Company operated as lessee under long-term leases properties of sixty-four other corporations, twenty-seven of which filed petitions as additional debtors for reorganization under the 77B proceedings. These twenty-seven corporations are listed on page 2 of the "Plan," Exhibit 3–C *infra,* and are referred to therein and herein as "Lessor Companies." The Philadelphia Rapid Transit Company, its subsidiaries and the "Lessor Companies" were referred to throughout the reorganization proceedings as The Philadelphia Rapid Transit Company System. Neither the Philadelphia Rapid Transit Company nor its subsidiaries (listed on Schedules "A" and "B", pages 15 and 16 of the "Plan") owned stock of the twenty-seven "Lessor Companies."

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7. On December 1, 1934, a "Plan of Reorganization of Philadelphia Rapid Transit Company System" was filed. On April 1, 1937, a "Revised Plan of Reorganization of Philadelphia Rapid Transit Company System" was filed. Neither of these Plans was approved and confirmed by the Court.

8. On December 1, 1937, a "Second Revised Plan of Reorganization of Philadelphia Rapid Transit Company System" was filed. Amendments to this "Plan" were filed on June 1, 1938, and on November 15, 1938. The "Second Revised Plan" as amended is herein called the "Plan." A copy of the "Plan" is submitted herewith, made a part hereof and marked Exhibit 3–C.

9. The "Plan" provided for the consolidation and merger of sixty-five of the corporations previously constituting the Philadelphia Rapid Transit Company System. Pursuant to the "Plan" an "Agreement of Consolidation and Merger" was adopted by said sixty-five corporations. A copy of said "Agreement of Consolidation and Merger" is submitted herewith, made a part hereof and marked Exhibit 4–D.

10. The "Plan" was approved and confirmed by the Court on November 14, 1939. A copy of the order of the Court entered November 14, 1939, confirming the "Plan" is submitted herewith, made a part hereof and marked Exhibit 5–E.

11. The "Plan" provided that petitioner, upon incorporation, would issue to holders of stock and stock trust certificates of twenty-one of said "Lessor Com-

panies,"[1] petitioner's 3%–6% Consolidated Mortgage Bonds in the amount of $31,973,597.78 and to holders of First Mortgage Bonds of two of said "Lessor Companies," petitioner's 3%–6% Consolidated Mortgage Bonds in the amount of $596,400.00. $200,000 of the $596,400 face amount 3%–6% Consolidated Mortgage Bonds were issued to holders of Doylestown and Willow Grove Railway Company First Mortgage 4% Bonds in exchange for $500,000 face amount of said bonds and the remaining $396,400 face amount were issued to holders of Darby, Media and Chester Street Railway Company 4½% First Mortgage Bonds in exchange for $991,000 face amount of said bonds. (See pages 8 and 20 of the Plan.")

12. Semi-annual interest in the amount of $10,000.00 due June 1, 1939, on the Doylestown and Willow Grove Railway Company 1st Mortgage 4% bonds of the face value of $500,000.00 was paid on or about July 30, 1939. "Fixed Interest Coupon No. 1" on the $200,000 face amount of 3%–6% Consolidated Mortgage Bonds exchanged for said $500,000 bonds was removed before delivery. Interest in the amount of $500 for the period from June 1, 1939, to July 1, 1939, was paid by petitioner at the rate of 3% on $200,000 on January 29, 1940.

13. Semi-annual interest in the amount of $22,297.50 due July 1, 1939, on the Darby, Media and Chester Street Railway Company 4½% First Mort-

[1] These "Lessor Companies" are listed on page 18 of the "Plan." Electric Traction Company and Peoples Traction Company appear on the list as "Electric & Peoples Traction."

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gage Bonds of the face value of $991,000 was paid on or about July 30, 1939. "Fixed Interest Coupon No. 1" on the $396,400 face amount of 3%–6% Consolidated Mortgage Bonds exchanged for said $991,000 bonds was removed before delivery.

14. In accordance with the "Plan" and as a result of said "Agreement of Consolidation and Merger" petitioner came into existence as a corporation on January 1, 1940, immediately after midnight, December 31, 1939.

15. Because of the operation during 1939 of the sinking fund for Peoples Passenger Railway Company stock trust certificates, the amount of $31,973,597.78 of bonds (Schedule D of the "Plan" which is Exhibit 3–C hereof) was reduced to $31,933,543.54 (total of face value of 3%–6% Consolidated Mortgage Bonds on Exhibit "A" of "Agreement of Consolidation and Merger" which is Exhibit 4–D hereof).

16. On January 29, 1940, petitioner, pursuant to said "Plan" executed and delivered its 3%–6% Consolidated Mortgage Bonds in the amount of $32,529,943.54,[2] dated January 1, 1939, and bearing interest from January 1, 1939,[3] to the Fidelity-Philadelphia

[2] For an explanation of the issuance of additional 3%–6% Consolidated Mortgage Bonds in the amount of $11,810,100, see the second footnote on page 20 of the "Plan" (Exhibit 3–C). No interest was paid on these bonds.

[3] Except that in the case of the $596,400 principal amount of said bond referred to in paragraphs 12 and 13 *supra* "Fixed Interest Coupon No. 1" was removed.

Trust Company, then and now Trustee for the bondholders, for authentication. The Trustee forthwith authenticated the bonds and delivered them to Drexel & Co., depositary, for delivery to the persons and in the amounts mentioned in paragraph 11 *supra*. A "Specimen" bond of such issue is submitted herewith, made a part hereof and marked Exhibit 6–F.

17. Said bonds were secured by a mortgage upon all of the properties of the petitioner, subject only to the prior encumbrances listed in Schedules E–1, E–2, E–3 and E–4 of the "Plan" (Exhibit 3–C). Said mortgage was executed and delivered by the petitioner on January 4, 1940, and recorded in Philadelphia County, Pennsylvania, on January 9, 1940, in Delaware County, Pennsylvania, on January 10, 1940, in Bucks County, Pennsylvania, on January 11, 1940, and in Montgomery County, Pennsylvania, on January 11, 1940. A copy of said Trust Indenture is submitted herewith, made a part hereof, and marked Exhibit 7–G.

18. A copy of the balance sheet with which petitioner opened its books in the late Spring of 1940 as of January 1, 1940, is submitted herewith, made a part hereof and marked Exhibit 8–H. The item listed under "Liabilities" on said balance sheet and designated as:

Matured interest and rents unpaid	$906,702.47

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was made up of items appearing on petitioner's books as follows:

Philadelphia Rapid Transit Co., dividends payable	$1,257.50
Lessor Co. dividends payable	2,406.87
Payment of rent for use of underliers' property due their stockholders	3,353.74
Drexel & Co. Agent—Exchange of Doylestown & Willow Grove Ry. Co. 1st Mtge. bonds [see paragraph 12, *supra*]	500.00
Drexel & Co. Agent—Exchange of Lessor Cos.' bonds for Philadelphia Transportation Co. 1st & Ref. 4% bonds	22,172.06
Fidelity-Philadelphia Trust Co.—Fixed interest for 1939 on issue of Philadelphia Transportation Co. 3%–6% consolidated mortgage bonds Series A	[1] 966,952.30
Total	996,702.47

[1] This sum was computed as follows:

3% ("Fixed Interest Coupons No. 1 and No. 2") on $31,933,543.54 bonds issued to stockholders of twenty-one "Lessor Companies" (See paragraphs 11 and 15, *supra*)	$958,006.30
1.5% ("Fixed Interest Coupon No. 2") on $596,400 bonds issued to bondholders of two "Lessor Companies" (see paragraphs 11, 12, and 13, *supra*)	8,946.00
	966,952.30

19. On January 29, 1940, petitioner delivered its check in the amount of $977,112.00 to the Trustee for bondholders of said 3%–6% Consolidated Mortgage Bonds with direction to the Trustees to pay to the bondholders an amount equivalent to 3% of the face amount of their respective bonds upon surrender for redemption of coupons numbered 1 and 2 affixed to said bonds which coupons were designated in the trust indenture as "Fixed Interest Coupons." This transaction was recorded on the books of petitioner by a debit of $977,112.00 against the liability shown on

the opening balance sheet (supplemented by adjusting credits not here material) as follows:

1940		
Jan. 1—Opening balance sheet (see par. 18)		$968,952.30
Jan. 29—Check to trustee	$977,112.00	
Jan. 31—Refund		7,794.00
May 17—Refund		1,212.00
Aug. 29—Refund		954.00
Aug. 31—Journal entry		199.70
	977,112.00	977,112.00

20. The item listed under "Liabilities" on the balance sheet with which petitioner opened its books as of January 1, 1940 (Exhibit 8–H) and designated as "Accrued Interest and Rent, Payable, $1,629,979.39", was made up of items appearing on Petitioner's books as follows:

Accrued interest on funded debt	$321,640.91
Accrued interest on unfunded debt	1,073.34
Accrued rents—City of Phila. Lines	474,579.37
Accrued rent—Delaware River Bridge Line	11,535.05
Accrued miscellaneous debits	925.54
Income interest on Phila. Transportation Co. consolidated 3%-6% bonds	820,225.18
	1,629,979.39

21. The item appearing in paragraph 20 as "Income Interest on Phila. Transportation Co. Consolidated 3%–6% Bonds $820,225.18" constituted the variable payment on said bonds required to be made on July 1, 1940. It was computed at the rate of 2.52% on $32,529,943.54 face amount of outstanding bonds in accordance with a report made to petitioner by Lybrand, Ross Bros. and Montgomery, Certified Public Accountants, dated April 29, 1940. A copy of said report is submitted herewith, made a part hereof and marked Exhibit 9–I. Rentals payable by Philadelphia Rapid Transit Company to the "Lessor Companies"

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for 1939 in the amount of $7,470,817,80 and an ad interim payment of $700,000 paid to certain "Lessor Companies" in 1939 in connection with the reorganization proceedings and pursuant to an order of the Federal District Court having jurisdiction thereof, are not reflected in said report.

22. On June 28, 1940 petitioner delivered its check in the amount of $819,754.58 to the Trustee for bondholders of said 3%–6% Consolidated Mortgage Bonds with direction to the Trustee to pay to the bondholders an amount equivalent to 2.52% of the face amount of their respective bonds upon surrender for redemption of coupon Number 1 affixed to said bonds which coupon was designated in the trust indenture as "Income Interest Coupon". This transaction was recorded on the books of petitioner by a debit of $819,754.58 against the liability of $820,225.18 shown on the opening balance sheet. Said sum was paid to the bondholders on July 1, 1940.

23. In accordance with regulations of the Public Utilities Commission of the Commonwealth of Pennsylvania, said payments of $966,952.30, $500.00 (see paragraph 12, *supra*) and $819,754.58 were not charged as an expense in petitioner's accounts for 1940.

24. Petitioner accrued on its books in 1940 the fixed and income interest payments due with respect to said 3%–6% Consolidated Mortgage Bonds and payable as follows:

Fixed interest (coupon 3)	July 1, 1940
Fixed interest (coupon 4)	Jan. 1, 1941
Income interest (coupon 2)	July 1, 1941

It deducted these amounts on its tax return for the year 1940 as interest and Respondent has allowed said deductions. These deductions are not in issue in this proceeding.

25. On its Corporation Income and Declared Value Excess Profits Tax Return for 1940 (Schedule 1-A "Reconciliation of Net Income Year Ending December 31, 1940") petitioner, among other items, subtracted the sum of $1,787,206.88 designated "Payment on Philadelphia Transportation Co. 3%-6% Consolidated Mortgage Bonds Schedule 12" from "Income per books" to arrive at "Net Income [Loss] per Tax Return." Photostatic copy of the petitioner's Consolidated Federal Income and Declared Value Excess Profits Tax Return for the calendar year 1940 is submitted herewith, made a part hereof and marked Exhibit 10-J.

26. On its Federal Income Tax Return for the calendar year 1940 petitioner claimed as a deduction $1,787,206.88 ($967,452.30[4] paid in January 1940 plus $819,754.58 paid in July 1940) as interest paid in computing its 1940 taxable income [loss].

27. Petitioner's consolidated Income and Declared Value Excess Profits Tax Return for the calendar year 1940 was filed on July 22, 1941 pursuant to an extension to August 15, 1941, of time for filing duly granted by the respondent on June 4, 1941. No waivers or extensions of the period for assessment were ever filed.

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[4] This amount consists of the $966,952.30 referred to in paragraphs 18 and 19, *supra*, and the $500 referred to in paragraph 12, *supra*.

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28. Photostatic copy of petitioner's consolidated Federal Income and Declared Value Excess Profits Tax Return for the calendar year 1941 is submitted herewith, made a part hereof and marked Exhibit 11-K.

29. In determining petitioner's net operating loss deduction for 1942 respondent disallowed the item of $1,787,206.88, claimed as a deduction on the return and referred to in paragraph 26 in computing the net operating loss for 1940 to be carried over to 1942.

30. In the event that it shall be finally determined that petitioner is entitled to carry forward a larger net operating loss from 1940 than that allowed by Respondent, petitioner is entitled to an increase in net operating loss deduction for 1942 to the same extent.

31. Respondent concedes that petitioner is entitled to additional deductions for ordinary and necessary business expenses for the years 1940 and 1941 as follows:

1940	$10,817.21
1941	13,227.42

Respondent concedes that by virtue of the allowance of such additional ordinary and necessary business expenses, petitioner is entitled to an increase in the net operating loss deduction for 1942 in the amount of $24,044.63.

32. Respondent concedes that by virtue of petitioner's duly filed election to accelerate the amortization of certain emergency facilities petitioner is entitled to an additional deduction in the year 1942 for amortization of such facilities in the amount of $7,435.00. The petitioner concedes that by reason of

said additional deduction for said amortization in the amount of $7,435.00, the deduction for Pennsylvania corporate net income tax as allowed in the deficiency notice should be reduced by $290.08.

33. The indebtedness incurred by petitioner and evidenced by said 3%–6% Consolidated Mortgage Bonds was not incurred or continued to purchase or carry obligations the interest upon which is wholly exempt from tax under Chapter 1, Sub-title A of the Internal Revenue Code.

W. R. Spofford,
WILLIAM R. SPOFFORD,
Counsel for Petitioner,
J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

The Tax Court of the United States

Docket No. 9893

PHILADELPHIA TRANSPORTATION COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

SUPPLEMENTAL STIPULATION OF FACTS

It is hereby stipulated with respect to the above-entitled proceeding that if the Consolidated Income and Excess Profits Tax Return of Philadelphia Rapid Transit Company for the calendar year 1939 is received in evidence (over objection of petitioner), the following statements may be accepted as facts.

1. Schedule No. 3 of said return is the "Philadelphia Rapid Transit System [Company] Consoli-

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dated Balance Sheet as of December 31, 1938" and "as of December 31, 1939." Under "Liabilities-Accounts Payable and Current Liabilities" on said balance sheet as of December 31, 1938, the item of $37,188,067.74 includes $28,692,245.94 accrued and unpaid rentals due the "Lessor Companies" mentioned in the principal Stipulation of Facts in this proceeding. Under "Liabilities-Accounts Payable and Current Liabilities" on said balance sheet as of December 31, 1939, the item $43,708,918.32 includes $35,463,063.74 accrued and unpaid rentals due said "Lessor Companies."

2. Upon audit of the Consolidated Income and Excess Profits Tax Return of Philadelphia Rapid Transit Company for the calendar year 1939, the Internal Revenue Agent (Mr. Charles Quinn) making such audit proposed to include certain items of additional income and disallow certain deductions claimed, which if sustained would have resulted in a deficiency of income and excess profits taxes of $190,558.26.

3. Among the items claimed as deductions, Revenue Agent Quinn proposed to disallow accrued rentals for the year 1939 payable by Philadelphia Rapid Transit Company to the "Lessor Companies" (referred to and described in the principal Stipulation) in the amount of $6,970,577.60. Said "Lessor Companies" kept their books of accounts and filed their tax returns on the cash receipts basis of accounting.

4. Subsequently, Mr. Quinn died before his recommendations were reviewed and the matter was assigned to Revenue Agent McLarren.

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5. Thereafter, conferences were held by representatives of the petitioner with representative of the respondent in which petitioner claimed a deduction for depreciation in excess of that claimed on the original return of Philadelphia Rapid Transit Company.

6. A copy of Revenue Agent McLarren's report to the Revenue Agent in Charge at Philadelphia, Pennsylvania is attached hereto, made a part hereof, and marked "Exhibit 12–L." The consolidated net income of $1,155,152.09 mentioned in said report is the net income as computed by Revenue Agent Quinn and results from his recommendation of the adjustments referred to in paragraph 2.

7. A copy of a letter dated May 29, 1941, sent to and received by the Philadelphia Rapid Transit Company in respect of the examination of its 1938 and 1939 income-tax returns is attached hereto, made a part hereof, and marked "Exhibit 13–M."

8. A copy of a letter dated August 21, 1941, sent by the Internal Revenue Agent in Charge to the Commissioner of Internal Revenue in respect of the 1938 and 1939 income-tax liability of Philadelphia Rapid Transit Company and related corporations is attached hereto, made a part hereof, and marked "Exhibit 14–N." No copy of this letter was furnished to petitioner.

William R. Spofford,
WILLIAM R. SPOFFORD,
Counsel for Petitioner,
J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

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FINDINGS OF FACT AND OPINION

The Tax Court of the United States

PHILADELPHIA TRANSPORTATION COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 9863. Promulgated November 28, 1947

A plan of reorganization under section 77–B of the Bankruptcy Act, approved November 14, 1939, provided for merger and consolidation of 65 companies previously constituting the Philadelphia Rapid Transit Co. System into a new company to be incorporated, the petitioner herein. It also provided that the new company, upon incorporation, should issue to holders of stock and stock trust certificates of certain of the merged companies, its 3 per cent–6 per cent consolidated mortgage bonds dated January 1, 1939, and bearing interest from that date. Petitioner's corporate existence began on January 1, 1940. On January 29, 1940, it issued and delivered its 3 per cent–6 per cent bonds as provided in the plan, and in January and July of 1940 made the interest payments called for by the bonds for the year 1939. These payments, aggregating $1,787,206.88, were deducted as interest in petitioner's 1940 return. Its books were kept and its returns made on an accrual basis. *Held*, petitioner was entitled to accrue and deduct from gross income for 1940, as interest, the amount which under the provisions of its bonds issued in that year it was obligated to pay and did pay as interest for the period January 1 to December 31, 1939. *Columbia River Paper Mills*, 43 B. T. A. 104; affd., 126 Fed. (2d) 1009; *Oregon Pulp & Paper Co.*, 47 B. T. A. 722; *Ernst Kern Co.*, 1 T. C. 249; and *Pressed Steel Car Co.* v. *Commissioner*, 152 Fed. (2d) 280, followed.

W. R. Spofford, Esq., Frederick L. Ballard, Esq., and *Sherwin T. McDowell, Esq.,* for the petitioner.

Brooks Fullerton, Esq., for the respondent.

The respondent determined a deficiency in the income tax of petitioner for the calendar year 1942 in the amount of $834,982.38. The sole issue presented for our consideration is whether the petitioner, in

computing the statutory "net operating loss deduction" for the year 1942, may deduct from gross income for 1940 amounts paid by it in that year in redemption of interest coupons for 1939 on its 3 per cent–6 per cent consolidated mortgage bonds. The parties have agreed upon other issues, and their agreement will be given effect upon settlement under Rule 50.

The evidence consists of a stipulation and supplemental stipulation of facts and certain documents introduced at the hearing.

FINDINGS OF FACTS

The facts as stipulated are so found.

Philadelphia Transportation Co. (hereinafter referred to as petitioner) is a Pennsylvania corporation, with office and principal place of business in Philadelphia, Pennsylvania. It keeps its books and files its tax returns on the accrual basis of accounting.

Petitioner's consolidated Federal income and declared value excess profits tax return for the calendar year 1942 was filed with the collector of internal revenue for the first collection district of Pennsylvania at Philadelphia on June 15, 1943, pursuant to an extension to June 15, 1943, of time for filing duly granted by respondent on May 7, 1943. In that return petitioner reported taxable net income (i. e., "normal tax net income") in the amount of $1,780,269.13 and liability for income tax in the amount of $747,517.96, which was paid.

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On October 23, 1945, petitioner paid to the collector of internal revenue at Philadelphia $925,052.05, of which $800,000 was in partial payment of the deficiency determined by respondent and $125,052.05 was interest on the $800,000 from March 15, 1943, to October 23, 1945. In its petition, filed December 27, 1945, petitioner claims a refund of taxes and interest paid, together with interest thereon as provided by statute.

On October 1, 1934, the Philadelphia Rapid Transit Co. (one of the petitioner's predecessors), a Pennsylvania corporation, operated a street railway system in Philadelphia. On October 1, 1934, it filed a voluntary petition under section 77–B of the Bankruptcy Act in the district court of the United States for the eastern district of Pennsylvania. It operated, as lessee under long term leases, properties of 64 other corporations, 27 of which filed petitions as additional debtors for reorganization under the 77–B proceedings. These 27 corporations are referred to in the reorganization "Plan" and herein as "Lessor Companies." The Philadelphia Rapid Transit Co., its subsidiaries and the "Lessor Companies" were referred to throughout the reorganization proceedings as "The Philadelphia Rapid Transit Company System." Neither the Philadelphia Rapid Transit Co. nor its subsidiaries owned stock of the 27 "Lessor Companies."

A plan known as the "Second Revised Plan of Reorganization," hereinafter called the "plan," was filed on December 1, 1937, and amended on June 1 and November 15, 1938, and approved on November 14, 1939.

Page 1 of the plan contains the following statement:

> * * * The public holders of stock and stock trust certificates of Lessor Companies will receive in exchange for their present securities, approximately $31,974,000 face amount of 3%–6% Consolidated Mortgage Bonds and approximately $12,301,000 par value of Participating Preferred Stock (of a par value of $20 per share) of Transportation Company and approximately $2,204,000 in cash, as hereinafter set forth. The total fixed annual interest (3%) on the said new bonds will be approximately $6,141,000 less, and the total maximum interest payable if earned (6%) on the said new bonds will be approximately $5,182,000 less, than the annual rentals formerly paid to the holders of such securities of Lessor Companies under the old leases.

The plan provided that petitioner, upon incorporation, would issue to holders of stock and stock trust certificates of 21 of the "Lessor Companies" petitioner's 3 percent-6 percent consolidated mortgage bonds, dated January 1, 1939, and bearing interest from that date, in the amount of $31,973,597.78[1] and to holders of first mortgage bonds of two of the "Lessor Companies" petitioner's 3 percent-6 percent consolidated mortgage bonds in the amount of $596,400. The 3 percent-6 percent consolidated mortgage bonds were to bear "Fixed Interest" of 3 percent per annum and an "additional 3 percent per annum only if and to the extent to which earned in any

[1] Later decreased to $31,933,543.54.

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year." The $596,400 face amount of 3 percent-6 percent consolidated bonds were to be, and were, in January 1940, issued as follows: $200,000 of said amount to holders of Doylestown and Willow Grove Railway Co. first mortgage 4-percent bonds in exchange for $500,000 face amount of said bonds and the remaining $396,400 face amount to holders of Darby, Media & Chester Railway Co. 4½-percent first-mortgage bonds in exchange for $991,000 face amount of said bonds. Semiannual interest in the amount of $10,000 due June 1, 1939, on the Doylestown & Willow Grove Railway Co. first-mortgage 4-percent bonds of the face value of $500,000 was paid by the trustees of the "Debtor" on or about July 30, 1939. "Fixed Interest Coupon No. 1" on the $200,000 face amount of 3 percent-6 percent consolidated mortgage bonds exchanged for said $500,000 bonds was removed before delivery. Interest in the amount of $500 for the period from June 1 to July 1, 1939, was on January 29, 1940, paid in cash by petitioner at the rate of 3 percent on $200,000. Semiannual interest in the amount of $22,297.50 due, July 1, 1939, on the Darby, Media & Chester Street Railway Co. 4½-percent first-mortgage bonds of the face value of $991,000 was paid by the trustees of the "Debtor" on or about July 30, 1939. "Fixed Interest Coupon No. 1" on the $396,400 face amount of 3 percent-6 percent consolidated mortgage bonds exchanged for said $991,000 bonds was removed before delivery.

The plan also provided for the consolidation and merger of 65 of the corporations previously constituting the Philadelphia Rapid Transit Co. System.

Pursuant to the plan, an "Agreement of Consolidation and Merger" was adopted by the 65 corporations. The plan and agreement provided that petitioner, a new corporation, would result from the merger and consolidation of the old companies.

Rentals on long-term leases, accrued but unpaid, were recorded on the books of account of Philadelphia Rapid Transit Co. in the amounts of $28,692,245.94 as of December 31, 1938, and $35,463,063.74 as of December 31, 1939.

From October 1934 to February 24, 1939, the "Lessor Companies" had received no payments in respect of those leases except three payments aggregating $2,300,000 paid by order of the United States District Court after October 1934 and prior to 1937, $2,000,000 paid pursuant to the order of the United States Circuit Court of Appeals for the Third Circuit on January 3, 1937, and $1,000,000 paid pursuant to order of the United States District Court entered June 6, 1938. All such payments were "ad interim allowances," without prejudice to any question pending in the reorganization proceedings.

On February 24, 1939, Union Traction Co. of Philadelphia, on behalf of itself and other lessor companies, filed a petition for a payment of $3,000,000. This was opposed by the Pennsylvania Public Utility Commission on the ground that such payment would dangerously deplete the working capital of the reorganized company and that the holders of stock and stock trust certificates of the lessor companies under the plan were to receive $2,204,000 in cash.

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On June 1, 1939, said petition of Union Traction Co. was heard by the court and, it appearing that the Pennsylvania Public Utility Commission had given consideration to the amount of cash which after reorganization would be available for rehabilitation and modernization of the system and that the city of Philadelphia had given consent to the action necessary on its part if and when the plan should be approved, the court ordered that an ad interim allowance of $700,000 be made to the Union Traction Co. and stated that such allowance was without prejudice to any question then pending.

Philadelphia Rapid Transit Co. filed a motion (verified on November 13, 1939) for confirmation of the plan, representing that, with the single exception of one class of creditors, all parties in interest including the Pennsylvania Public Utility Commission and the city of Philadelphia, had accepted the plan and that an overwhelming majority of the affected stockholders and creditors, representing in each class a majority in excess of the required statutory majority, had accepted the plan. The "Debtor" submitted drafts, for approval prior to execution, of substantially all documents necessary to consummate the plan, the consolidation of the several corporations, and the transfer of property.

On November 14, 1939, "Drexel & Co., Agent" for each of the corporations which were parties to the plan, filed an "Affidavit re Acceptances of Plan" showing the percentage of acceptances of the plan as of the close of business November 13, 1939, by holders

of affected issues of stock, stock trust certificates, and bonds.

On November 14, 1939, the motion of the "Debtor" for confirmation of the plan was heard. The court found, among other facts, that the plan had been submitted to and approved by the Pennsylvania Public Utility Commission, had been accepted by the city of Philadelphia and by all necessary parties except one class of creditors, for the protection of whose rights provision was made, and that "12. The compromise set forth in the Plan is approved as reasonable, fair and equitable."

The court ordered that:

> 8. The new company, upon confirmation of the Plan, will be authorized to take all action necessary to carry out the Plan and all authorizations, approvals or consents required by law have been obtained.

and that:

> 13. The Plan provides that the new company shall assume liability for the payment of, and will pay in full in cash, all taxes legally due or which may become due to the United States of America, the Commonwealth of Pennsylvania, the City of Philadelphia, and/or any other taxing authority by the debtor, the additional debtors, the trustees thereof, other merging companies and/or wholly-owned subsidiaries whether or not proofs of claim therefor have been filed in this reorganization proceeding (unless such taxes are fully paid and satisfied prior to the confirmation of the Plan) and such taxes shall be assessed against, collected from, and

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paid by transportation company[2] in the same manner subject to the same provisions of law as would be applicable to the debtor, the additional debtors, other merging companies and wholly-owned subsidiaries had this reorganization proceeding not intervened.

and that "15. The Plan is hereby confirmed and approved."

On the same day, November 14, 1939, the court entered an order approving the documents and the terms and procedure for carrying out the order confirming the plan, providing, among other matters, that "3. The transfer books for all securities of all companies parties to the Plan shall be closed as of 3:00 P. M. on the date of this order," and making provision for the adjustment of the interest on the "First and Refunding Bonds of the New Company" and on the "Consolidated Mortgage Bonds of the New Company" in those instances where the holders of bonds which were to be surrendered in exchange for the bonds of the new company had received payments of interest applicable to the year 1939 on their old bonds.

In accordance with the plan and as a result of the "Agreement of Consolidation and Merger," petitioner came into existence as a corporation on January 1, 1940, immediately after midnight, December 31, 1939.

On January 29, 1940, petitioner, pursuant to said plan, executed and delivered its 3 per cent–6 per cent consolidated mortgage bonds in the amount of $32,529,943.54, dated January 1, 1939, and bearing in-

[2] "Transportation company" refers to petitioner.

terest from January 1, 1939,[3] to the Fidelity-Philadelphia Trust Co., then and now trustee for the bondholders, for authentication. The trustee forthwith authenticated the bonds and delivered them to Drexel & Co., depository, for delivery.

Said bonds were secured by a mortgage upon all of the properties of the petitioner, subject only to the prior encumbrances listed in the plan. The trust indenture evidencing the mortgage was executed and delivered by the petitioner on January 4, 1940, and recorded in Philadelphia County, Pennsylvania, on January 9, 1940, in Delaware County, Pennsylvania, on January 10, 1940, in Bucks County, Pennsylvania, on January 11, 1940, and in Montgomery County, Pennsylvania, on January 11, 1940.

On January 29, 1940, petitioner delivered its check in the amount of $977,112 to the trustee for bondholders of the 3 per cent-6 per cent consolidated mortgage bonds, with direction to the trustees to pay to the bondholders an amount equivalent to 3 per cent of the face amount of the respective bonds upon surrender for redemption of coupons numbered 1 and 2 affixed to the bonds, which coupons were designated in the trust indenture as "Fixed Interest Coupons." This transaction was recorded on the books of petitioner by a debit of $977,112 against two items of liability, $966,952.30 and $500, appearing on journal entry No. 1, hereinafter mentioned. Subsequently, the item of

[3] Except that in the case of the $596,400 principal amount of said bonds, heretofore mentioned, "Fixed Interest Coupon No. 1" was removed.

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$977,112 was decreased by proper refunds and credits to $967,452.30. ($966,952.30 plus $500.)

In the operation of an electric railway system petitioner is subject to regulations issued by the Pennsylvania Public Utility Commission and is required to keep its accounts in accordance therewith. Pursuant to such regulations, petitioner prepared its journal entry No. 1, "to Open the Books of Philadelphia Transportation Company on January 1, 1940." This was prepared in the late spring of 1940 as of January 1, 1940.

On journal entry No. 1 "To Open the Books of Philadelphia Transportation on January 1, 1940," under "Liabilities," the following entries were made:

Current liabilities		
Matured Interest Dividends and Rents Unpaid.	$996, 702. 47	
Phila. Rapid Transit Co. Dividends Payable.	1, 257. 50	Unpresented checks at 1/1/40 issued by merged companies.
Lessor Companies Dividends Payable.	2, 466. 87	
Payment of Rent for Use and Occupancy due Lessor Co.'s Stockholders.	3, 353. 74	
Drexel & Co. Agent—Exchange of Doylestown & Willow Grove St. Railway Co. 1st Mtge. Bonds.	500. 00	Payments due under plan of reorganization and/or order of U. S. District Court.
Drexel & Bo. Agent—Exchange of Lessor Companies Bonds for Phila. Transp. Co. 1st & Refunding 4% Bonds.	22, 172. 06	
Fidelity-Phila. Tr. Co. Trustee-Fixed Interest for year 1939 on Phila. Transp. Co. Consolidated Mtge. Bonds "Series A."	966, 952. 30	
Accrued Interest, Dividends & Rents Payable.	1, 629, 979. 39	
Accrued Interest on Funded Debt.	311, 640. 91	Interest accrued but not due at 1/1/40 on all outstanding funded debts of system.
Accrued Interest on Unfunded Debt.	1, 073. 34	Transferred from books of Phila. Rapid Transit Company.
Accrued Rents—City of Phila. Lines.	474, 579. 37	
Accrued Rent—Delaware River Bridge Line.	11, 535. 05	
Accrued Miscellaneous Debits...	925. 54	Accrued balance at 1/1/40 of an amount due for fees for registration of stock, trusteeship of bonds, etc. on issues of securities outstanding after reorganization.
Income Interest on Phila. Transportation Co. Consolidated 3%–6% Bonds.	820, 225. 18	Income interest accrued on Consolidated 3%–6% Bonds for year 1939.

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All of the said items are reflected in petitioner's opening balance sheet as of January 1, 1940.

The liability appearing in the journal entry as "Drexel & Co., Agent—Exchange of Doylestown & Willow Grove St. Railway Co. 1st Mtge. Bonds $500.00" was paid on January 29, 1940, pursuant to court order in the adjustment in respect of 1939 made upon the exchange of petitioner's 3 per cent–6 per cent consolidated mortgage bonds for bonds of "Lessor Companies."

The liability appearing in the journal entry as "Drexel & Co. Agent—Exchange of Lessor Companies Bonds for Phila. Transp. Co. 1st & Refunding 4% Bonds $22,172.06" was entered pursuant to court order in the adjustment in respect of 1939 made upon the exchange of petitioner's first and refunding mortgage 4 per cent bonds for bonds of the "Lessor Companies." This item was not claimed as a deduction from gross income on petitoner's 1940 return.

The liability appearing in the journal entry as "Fidelity-Phila. Tr. Co. Trustee-Fixed Interest for year 1939 on Phila. Transp. Co. Consolidated Mtge. Bonds Series 'A' $996,952.30" was paid as part of the item $977,112 paid by petitioner on January 29, 1940. It was computed as follows:

3% (used to redeem "Fixed Interest Coupons No. 1 and No. 2") on $31,933,543.54 face value of 3%–6% Consolidated Mortgage Bonds issued to stockholders and stock trust certificate holders of 21 "Lessor Companies"	$958,006.30
1.5% (used to redeem "Fixed Interest Coupon No. 2") on $596,400.00 face value of the same bonds issued to holders of "Lessor Companies" bonds on which latter bonds part interest for 1939 had been paid	8,946.00
	966,952.30

The item appearing in the journal entry as "Income Interest on Phila. Transportation Co. Consolidated 3 per cent-6 per cent Bonds $820,225.18" constituted the variable payment on said bonds required to be made on July 1, 1940. It was computed at the rate of 2.52 per cent on $32,529,943.54 face amount of outstanding bonds in accordance with a report made to petitioner by Lybrand, Ross Brothers & Montgomery, certified public accountants, dated April 29, 1940.

In said report, Lybrand, Ross Brothers & Montgomery stated that:

> * * * the holders of your company's Consolidated Mortgage 3%-6% Series A bonds, due January 1, 2039, are to receive income interest not to exceed three per cent based on the net income for the calendar year 1939, under [the hypothesis that] the plan of reorganization being [became] effective as of January 1, 1939. We have stated the income account for the calendar year 1939 after giving effect to said plan. [Words in brackets supplied.]

Rentals payable by the Philadelphia Rapid Transit Co. to the "Lessor Companies" for 1939 in the amount of $7,470,817.80 and an interim payment of $700,000 paid to certain "Lessor Companies" in 1939 in connection with the reorganization proceedings and pursuant to an order of the Federal District Court having jurisdiction thereof, are not reflected in said report.

On June 28, 1940, petitioner delivered its check in the amount of $819,754.48 to the trustee for bondholders of the 3 percent-6 percent consolidated mort-

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gage bonds, with direction to the trustee to pay to the bondholders an amount equivalent to 2.52 per cent of the fact amount of their respective bonds upon surrender for redemption of coupon No. 1 affixed to the bonds, which coupon was designated in the trust indenture as "Income Interest Coupon." This transaction was recorded on the books of petitioner by a debit of $819,754.58 against the liability of $820,225.18 shown on journal entry No. 1. Said sum was paid to the bondholders on July 1, 1940.

In accordance with regulations of the Public Utility Commission of the Commonwealth of Pennsylvania, the payments of $966,952.30 and $500 and $819,754.58 were not charged as an expense in petitioner's accounts for 1940.

Petitioner accrued on its books in 1940 the fixed and income interest payments due with respect to the 3 percent-6 percent consolidated mortgage bonds and payable as follows:

Fixed interest (coupon 3)	July 1, 1940
Fixed interest (coupon 4)	Jan. 1, 1941
Income interest (conpon 2)	July 1, 1941

It deducted these amounts on its tax return for the year 1940 as interest and respondent has allowed the deductions. These deductions are not in issue in this proceeding.

On its corporation income and declared value excess profits tax return for 1940 (Schedule 1–A "Reconciliation of Net Income Year Ending December 31, 1940") petitioner, among other items, subtracted the sum of $1,787,206.88 designated "Payment on Philadelphia Transportation Co. 3%-6% Consolidated

Mortgage Bonds Schedule 12" from "Income per books" to arrive at "Net Income [loss] per Tax Return."

On its Federal income tax return for the calendar year 1940 petitioner claimed as a deduction $1,787,206.88 ($967,452.30 paid in January 1940, plus $819,754.58 paid in July 1940) as interest paid in computing its 1940 taxable income [loss].

Petitioner's consolidated income and declared value excess profits tax return for the calendar year 1940 was filed on July 22, 1941, pursuant to an extension to August 15, 1941, of time for filing duly granted by the respondent on June 4, 1941. No waivers or extensions of the period for assessment were ever filed.

In determining petitioner's net operating loss deduction for 1942, respondent disallowed the item of $1,787,206.88 claimed as a deduction on the return in computing the net operating loss for 1940 to be carried over to 1942. Except for minor items in respect of which the parties are now in agreement, that disallowance is the cause of the deficiency.

By letter dated September 23, 1940, petitioner asked respondent for a specific ruling. A letter to petitioner dated October 9, 1940, signed "Timothy C. Mooney, Deputy Commissioner by L. K. Sunderlin, Chief of Section," stated:

> Mr. Renner has requested a specific ruling with regard to the treatment, for the purposes of the Federal income tax, of the amounts paid by your company as interest on its Consolidated Mortgage Bonds, the filing of ownership cer-

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tificates on form 1012 with respect to such interest payments, and the withholding of tax at the source with regard to the interest payments made to nonresident alien stockholders.

and ruled:

> * * * The distribution under consideration in the instant case is held to represent a payment of interest on an outstanding obligation. Accordingly, as the payments made in January 1940 represent payments of interest, ownership certificates are required with respect to such payments. Furthermore, tax at the prescribed rate must be deducted and withheld from all payments of interest made to nonresident alien bondholders. (Section 143 (b) of the Internal Revenue Code and section 143 (b) of the Internal Revenue Code, as amended.)

On its return for 1940 petitioner reported a "Normal net income" [loss] of $3,077,666.75, computed as follows:

Reconciliation of Net Income, Year Ending December 31, 1940

Income per books		$185,624.25
Additions:		
Net short term capital gain Schedule # 2	$70.22	
Federal Income Tax Schedule #3	47,696.09	47,766.31
		233,390.56
Deductions:		
Payments on Phila. Transportation Co. 3%–6% Consolidated Mortgage Bonds Schedule 12	1,787,206.88	
Depreciation—Excess of schedule over books Schedule #15	961,482.54	
Other deductions not here material	549,744.88	
	3,298,434.30	
85% of Dividends Received, Schedule #7	12,623.01	3,311,057.31
	(Loss)	3,077,666.75

The internal revenue agent in charge at Philadelphia, Pennsylvania, wrote petitioner under date of January 19, 1943, as follows:

> In re: Income Tax Return
> Year(s) covered: 1940
>
> Upon examination of your income tax return(s) for the year(s) indicated above, the conclusion has been reached that it (they) should be accepted as filed.
>
> I am sure you will appreciate that should subsequent information be received which would materially change the amount reported, it will be necessary under existing laws to redetermine your tax liability.

OPINION

HARLAN, *Judge:* The respondent contends that the payments made by petitioner in the redemption of the 1939 coupons were not payments of interest; that the obligation to redeem the 1939 coupons did not accrue in 1940; that it was imposed in 1939 and became a fixed liability on November 14, 1939; that the 1939 coupons were to counterbalance the difference between 1939 rentals and the $700,000 *ad interim* payment; that the amount of $1,787,206.88 paid to redeem the 1939 coupons was computed on 1939 income; that it is treated on petitioner's books exactly in accordance with respondent's determination; that this obligation became fixed in 1939; that petitioner may not in 1940 accrue "interest" on the same obligation for the years 1939 and 1940; and that the accrual of the alleged 1939 interest on the accrual of the actual

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1940 interest as deductions from gross income of 1940 distorts petitioner's net operating loss for that year.

The petitioner contends that the amounts it paid in redemption of the 1939 coupons on its 3 percent-6 percent consolidated mortgage bonds constituted interest on indebtedness which accrued in 1940 and hence was deductible from gross income for that year. In the alternative it contends that the deductions claimed on its 1940 income tax return were allowed by the respondent within the meaning of the Internal Revenue Code, and respondent, therefore, erred in disregarding them in computing its income-tax liability for 1942.

Section 23 (b) of the Internal Revenue Code permits a taxpayer to deduct all interest paid or accrued within the taxable year on indebtedness.

This Court has held in a number of cases, relied upon and cited by petitioner, that interest accrued or paid under circumstances substantially the same as those here involved is deductible. *Columbia River Paper Mills,* 43 B. T. A. 104; affd., 126 Fed. (2d) 1009; *Oregon Pulp & Paper Co.,* 47 B. T. A. 772 (petition for review dismissed, C. C. A., 9th Cir., Nov. 2, 1943); *Ernst Kern Co.,* 1 T. C. 249; *Pressed Steel Car Co.* v. *Commissioner,* 152 Fed. (2d) 280, affirming per curiam, Tax Court memorandum opinion, Docket No. 107623, August 16, 1944. The Circuit Court of Appeals for the Seventh Circuit reached a contrary conclusion on similar facts in *Commissioner* v. *Drovers Journal Publishing Co.,* 135 Fed. (2d) 276. The latter case is relied upon by the respondent.

The above-cited cases, excluding the *Drovers* case, which we respectfully decline to follow, require that our decision on the issue presented for our consideration be in favor of petitioner. Having reached this conclusion, no useful purpose would be served by any detailed discussion of the respondent's contentions and argument. Suffice to say that we do not have before us the question of the tax treatment to be accorded purchase money applied to an indebtedness existing prior to the acquisition of property, or an instance where property was acquired subject to the obligation of a third party. Cases such as *Pratt-Mallory Co.* v. *United States* (Ct. Cls.), 12 Fed Supp. 1020, 1023; *Rodney, Inc.,* v. *Commissioner,* 145 Fed. (2d) 692, affirming 2 T. C. 1020; *Koppers Co.,* 3 T. C. 62; affd., 151 Fed. (2d) 267; *Magruder* v. *Supplee,* 316 U. S. 394; *Automatic Sprinkler Co. of America,* 27 B. T. A. 160, cited by respondent, do not, therefore, have any application here. The plan of reorganization does not contain any provision imposing upon petitioner, as the new company, a liability to discharge the obligation of any other party to the reorganization to pay rentals or interest. When petitioner made the payments in redemption of the 1939 coupons it was paying its own obligation—not that of another party. The 3 per cent–6 per cent consolidated mortgage bonds constituted an indebtedness of petitioner. These bonds and the coupons in redemption of which the payments in controversy were made, all required the payment of the questioned sums as interest. The respondent himself recognized that these payments constituted inter-

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est when, on October 9, 1940, in advising petitioner that it was required to withhold income tax on payments made to nonresident alien bondholders, he said: "The distribution under consideration in the instant case is held to represent a payment of interest on an outstanding obligation." Inasmuch as petitioner did not come into existence until 1940, did not issue its bonds until 1940, did not exchange them with the depositing security holders in the reorganization proceedings until 1940, and did not actually undertake any liability until all these things had taken place, it was impossible for the interest to accrue prior to 1940. Inherent in the accrual of an obligation is the existence of an obligor, and petitioner's obligation accrued in 1940 when it came into existence and was legally capable of contracting obligations. We hold that the petitioner properly accrued and deducted in its income tax return for 1940, interest in the amount of $1,787,-206.88 which it paid in that year.

Having reached this conclusion, we deem it unnecessary to discuss or decide the petitioner's alternative contention.

Reviewed by the Court.

Decision will be entered under Rule 50.

THE TAX COURT OF THE UNITED STATES

Washington 25, D. C.

Docket No. 9893

PHILADELPHIA TRANSPORTATION COMPANY,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT

DECISION

Pursuant to the Court Findings of Facts and Opinion, promulgated November 28, 1947, the parties herein having filed an agreed computation of tax on February 17, 1948, it is

Ordered and decided: That there is an overpayment in income tax for the calendar year 1942, of $699,063.69, which amount was paid after the mailing of the notice of deficiency.

Entered Feb. 19, 1948.

(Signed) BYRON B. HARLAN,
Judge.

U. S. GOVERNMENT PRINTING OFFICE: 1948

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EXHIBIT 3-C: PLAN OF REORGANIZATION.

Second Revised

PLAN OF REORGANIZATION

of

PHILADELPHIA RAPID TRANSIT COMPANY SYSTEM

Dated December 1, 1937
Amended June 1, 1938 and November 15, 1938

THE NATURE OF THE PLAN.

Under the Plan, Philadelphia Rapid Transit Company (hereinafter called "P.R.T.") and present Lessor Companies will merge to form a new company, PHILADELPHIA TRANSPORTATION COMPANY (hereinafter called "Transportation Company") which will be a single owning and operating company. The public holders of stock and stock trust certificates of Lessor Companies will receive in exchange for their present securities, approximately $31,974,000 face amount of 3%-6% Consolidated Mortgage Bonds and approximately $12,301,000 par value of Participating Preferred Stock (of a par value of $20 per share) of Transportation Company and approximately $2,204,000 in cash, as hereinafter set forth. The total fixed annual interest (3%) on the said new bonds will be approximately $6,141,000 less, and the total maximum interest payable if earned (6%) on the said new bonds will be approximately $5,182,000 less, than the annual rentals formerly paid to the holders of such securities of Lessor Companies under the old leases. The accumulated dividends on P.R.T. Preferred Stock will be waived and the

holders of such stock will receive, in exchange for each share of P.R.T. Preferred Stock, one half share of Participating Preferred Stock of Transportation Company and one half share of Common Stock of Transportation Company and $1 in cash. The holders of P.R.T. Common Stock will receive one share of Common Stock of Transportation Company in exchange for each share of P.R.T. Common Stock. Certain funded debt of P.R.T. and of Lessor Companies will be refunded with new bonds or obligations of Transportation Company and the balance of the present funded debt of said companies will remain outstanding and become, by virtue of the merger, the obligations of Transportation Company, which will assume all obligations of merging companies. Certain mortgages and ground rents on property of merging companies or their wholly-owned subsidiaries will remain outstanding.

THE PLAN.

SECTION 1. *The Corporations Parties to the Plan*

The Corporations Parties to the Plan will be:

Philadelphia Rapid Transit Company and twenty-seven street railway and traction companies herein referred to collectively as "Lessor Companies" and classified, for purposes of the Plan, in three classes, as follows:

Class A Lessor Companies, viz:

street railway companies whose systems are leased to intermediate traction companies listed below as "Class B Lessor Companies", such Class A Lessor Companies being as follows:

Catherine and Bainbridge Streets Railway Company of the City of Philadelphia, The,
Citizens Passenger Railway Company of Philadelphia,

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Continental Passenger Railway Company of Philadelphia,
Empire Passenger Railway Company of Philadelphia,
Fairmount Park and Haddington Passenger Railway Company, The,
Frankford and Southwark Philadelphia City Passenger Railroad Company,
Germantown Passenger Railway Company,
Green and Coates Street Philadelphia Passenger Railway Company,
Peoples Passenger Railway Company,
Philadelphia City Passenger Railway Company,
Philadelphia and Darby Railway Company, The,
Philadelphia and Gray's Ferry Passenger Railway Company,
Ridge Avenue Passenger Railway Company,
Second and Third Streets Passenger Railway Company of Philadelphia,
Seventeenth and Nineteenth Streets Passenger Railway Company of Philadelphia,
Thirteenth and Fifteenth Streets Passenger Railway Company of the City of Philadelphia,
Union Passenger Railway Company of Philadelphia,
West Philadelphia Passenger Railway Company.

Class B Lessor Companies, viz:

intermediate traction and street railway companies whose systems are leased to Union Traction Company of Philadelphia listed below under "Class C Lessor Companies", such Class B Lessor Companies being as follows:

Philadelphia Traction Company,
Electric Traction Company of Philadelphia, The,
Peoples Traction Company,
Hestonville, Mantua and Fairmount Passenger Railroad Company.

Class C Lessor Companies, viz:

traction and street railway companies, other than wholly owned subsidiaries of P.R.T., whose systems are leased direct to P.R.T., such Class C Lessor Companies being as follows:

Union Traction Company of Philadelphia,
Darby, Media and Chester Street Railway Company,
Darby & Yeadon Street Railway Company,
Doylestown and Willow Grove Railway Company,
Philadelphia and Willow Grove Street Railway Company.

SECTION 2. *Formation of Philadelphia Transportation Company.*

By a Merger Agreement in a form to be approved by or on behalf of all corporations parties to the Plan, P.R.T., all Lessor Companies and street railway companies whose stock is wholly owned by Lessor Companies and/or P.R.T. as listed in Schedule "A" hereto attached and made a part hereof, will merge into a single company with the corporate title "Philadelphia Transportation Company". By virtue of this merger Transportation Company will own, either directly or through stock ownership, all franchises and property owned by P.R.T. or leased to P.R.T. by merging companies. The ownership will be direct except in the case of certain subsidiaries of merging companies listed in Schedule "B" attached which will remain in existence as subsidiaries of Transportation Company. Property not owned by or leased to P.R.T. and property (other than securities of any system company) representing the sale proceeds of property formerly covered by the old leases, now held in special funds subject to the leases, is not included in the merger.

As a part of the Plan, and either prior to or subsequent to the aforesaid merger: (1) P.R.T. or its successor, Transportation Company, will acquire all the

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corporate powers, franchises, property, rights and credits of Philadelphia Rural Transit Company, under and pursuant to the Act of June 26, 1931, P. L. 1402; (2) Darby, Media and Chester Street Railway Company or its successor, Transportation Company, will acquire all the corporate powers, franchises, property, rights and credits of D M & C Bus Company, under and pursuant to the Act of June 26, 1931, P. L. 1402; and (3) P.R.T. or its successor, Transportation Company, will acquire all the corporate powers, franchises, property, rights and credits of Pennsylvania Rapid Transit Company, under and pursuant to the Act of July 2, 1937, P. L. 2824. The corporate powers, franchises, property, rights and credits so acquired will, following such acquisition and the aforesaid merger, be owned by Transportation Company.

SECTION 3. *Capitalization of Transportation Company.*

The authorized capitalization of Transportation Company will be as follows:

(a) *First and Refunding Mortgage Bonds:*

These bonds will be secured by a Mortgage and Deed of Trust creating a direct lien upon all surface railway and motor bus franchises and lines owned by Transportation Company and all real estate used in connection with such surface lines and certain additional real estate, (the lien on which said real estate owned by wholly-owned subsidiaries will be created by adherence mortgage), subject only to such existing prior lien bonds, mortgages and ground rents as are not to be presently refunded, as shown on Schedule "C". The First and Refunding Mortgage Bonds will be further secured by the pledge of the equity in the stock of Market Street Elevated Passenger Railway Company. Bonds secured by this First and Refunding Mortgage will be issuable for the following purposes only:

(i) For refunding purposes as follows:

To refund the bonds listed below in Section 4 (e);

To refund First and Refunding Mortgage Bonds as the same may from time to time mature;

To refund certain bonds, mortgages and ground rents of, or on property owned by, companies merging to form Transportation Company and companies which will be wholly-owned subsidiaries of Transportation Company, as shown in Schedule "C";

To refund any other funded debt, mortgages or ground rents which may at any time be a direct prior lien on property subject or made subject to the lien of the First and Refunding Mortgage; subject, however, as a condition precedent to such refunding, to a certificate of one or more engineers or other representatives, selected by the corporate Trustees of the First and Refunding and Consolidated Mortgage Bonds, that such refunding is reasonably necessary and proper for the preservation and efficient operation of the property or business of Transportation Company and/or its wholly-owned subsidiaries.

(ii) To provide new capital up to not more than 75% of the cost or value of additions, betterments or extensions to the property of Transportation Company and/or its wholly-owned subsidiaries. The mortgage will require, as a condition precedent to the issue of bonds for this purpose, a certificate of one or more engineers or other representatives, selected by the corporate Trustees of the First and Refunding and Consolidated Mortgage Bonds, as to the cost and value of such additions, betterments or extensions and as to the fact that they are reasonably necessary and proper for the efficient operation and/or extension of the property or business of Transportation Company and/or its wholly-owned subsidiaries.

The Mortgage and Deed of Trust securing these First and Refunding Mortgage Bonds will provide for

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the issue of bonds from time to time for the purposes above set forth in different series with different maturities, different rates of interest, different call provisions, and other different provisions; and will provide for the release of the lien thereof on any property which may become no longer used or useful in the business of Transportation Company, upon the payment of the salvage proceeds thereof, if any, to the Trustee either for the sinking fund or for use for additions, betterments and extensions to property subject or made subject to the lien thereof and if a new transportation facility is substituted for such property so abandoned Transportation Company's property interest in the same shall be made subject to the lien thereof either directly or through stock ownership.

The Mortgage and Deed of Trust will contain sinking fund provisions requiring the payment to the Trustee annually of an amount equal to One per cent. (1%) of the maximum face amount of First and Refunding Mortgage Bonds which shall at any one time have been outstanding in the hands of the public. Bonds held in the treasury of Transportation Company, whether or not pledged, and bonds held in the sinking fund shall not be deemed to be outstanding for the purpose of computing sinking fund payments. Bonds purchased for the sinking fund shall be kept alive and the interest thereon added to the sinking fund payments. If at any time all outstanding First and Refunding Mortgage Bonds shall be paid and cancelled, the bonds held in the sinking fund shall be cancelled. If at any subsequent time there are such bonds issued and outstanding, the amount thereof shall be taken, as aforesaid, as the amount on the basis of which payments into the sinking fund shall be calculated. This sinking fund will be applicable to the purchase of First and Refunding Mortgage Bonds and/or prior lien bonds, mortgages and ground rents shown on Schedule "C", or which may be refundable by First and Refunding Mortgage Bonds as aforesaid.

The Mortgage and Deed of Trust will be in a form to be approved by or on behalf of all corporations parties to the Plan.

All of the First and Refunding Mortgage Bonds to be presently issued and distributed as set forth in Section 4 (e) of this Plan will be of a single series and will be dated January 1, 1939 and mature on January 1, 1969, will bear interest at the rate of 4% per annum, with a provision requiring Transportation Company to pay interest without deduction for any Pennsylvania Personal Property Taxes or Corporate Loans Taxes not in excess of five mills per annum in the aggregate and will be callable by Transportation Company, or by the Trustee of the sinking fund, at any time, in whole or in part, at face amount and accrued interest.

(b) *Consolidated Mortgage Bonds:*

These bonds will be secured by a Mortgage and Deed of Trust junior to the Mortgage and Deed of Trust securing the First and Refunding Mortgage Bonds above described and covering the same franchises and properties. Bonds secured by this Consolidated Mortgage and Deed of Trust will be issuable for the following purposes only:

(i) In exchange for stock and/or stock trust certificates of Lessor Companies outstanding in the hands of the public and/or pledged to secure outstanding collateral trust bonds, as hereafter in Section 4 of this Plan set forth.

(ii) For refunding the bonds listed below in Section 4 (f) and for refunding Consolidated Mortgage Bonds and also for other refunding and additions, betterments and extensions as hereinbefore set forth in the case of the First and Refunding Bonds under paragraphs (a), (i) and (ii) of this Section and subject to the same restrictions and conditions.

The Mortgage and Deed of Trust securing these Consolidated Mortgage Bonds will provide for the issue of

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bonds from time to time for the purposes set forth above in different series with different maturities, different rates of interest, different sinking fund provisions and different call provisions, and other different provisions; and will provide for the release of the lien thereof on any property which may become no longer used or useful in the business of Transportation Company, upon the payment of the salvage proceeds thereof, if any, to the Trustee either for the sinking fund or for use for additions, betterments and extensions to property subject or made subject to the lien thereof and if a new transportation facility is substituted for such property so abandoned Transportation Company's property interest in the same shall be made subject to the lien thereof either directly or through stock ownership.

The Mortgage and Deed of Trust will contain sinking fund provisions as follows:

When and as the present sinking fund requirements of the outstanding bonds of merging companies and/or of wholly-owned subsidiaries are reduced through retirement or refunding of such bonds, payments equal to the amount of such reductions, but not exceeding in the aggregate $300,000 per year, shall be made annually into a sinking fund in the hands of the Trustee of the Consolidated Mortgage Bonds. Transportation Company will also covenant that in any year in which it shall pay any dividend on its Common Stock it will, before paying such dividend, pay into such sinking fund the additional sum of $200,000. The sinking fund for the Consolidated Mortgage Bonds shall be applied to the purchase, at not exceeding face value, of Consolidated Mortgage Bonds. Bonds purchased for the sinking fund shall be cancelled.

The Mortgage and Deed of Trust will be in a form to be approved by or on behalf of all corporations parties to the Plan.

All of the Consolidated Mortgage Bonds to be presently issued and distributed as set forth in Section 4 (a) and (f) of this Plan will be of a single series and will be dated January 1, 1939 and mature on January 1, 2039.

They will bear a fixed rate of interest at the rate of 3% per annum and in any year in which Transportation Company would have net income otherwise available for dividends, then such income shall be applied toward the payment of additional interest upon the said Bonds; Provided, however, that such payments of additional interest on said Bonds shall be to the nearest ½ of 1% for which such net income is available and shall never for any year exceed 3% in addition to the fixed interest of 3% per annum. Such additional interest shall be non-cumulative and shall be paid only for such years in which the same shall be earned as aforesaid. There will be a provision requiring Transportation Company to pay interest without deduction for any Pennsylvania Personal Property Taxes or Corporate Loans Taxes not in excess of five mills per annum in the aggregate and said bonds will be callable by Transportation Company, or by the Trustee of the sinking fund, at any time, in whole or in part, at face amount and accrued interest.

(c) *Certain Prior Lien Bonds, Mortgages and Ground Rents to Remain Outstanding:*

In addition to the First and Refunding and Consolidated Mortgage Bonds to be issued by Transportation Company as set forth in (a) and (b) above, there will remain outstanding certain now existing prior lien bonds, mortgages and ground rents of, or on property owned by, companies merging to form Transportation Company and companies which will be wholly owned subsidiaries of Transportation Company, as shown in Schedules "E-1," "E-2" and "E-3."

(d) *Participating Preferred Stock:*

A presently authorized issue of approximately 755,100 shares of Participating Preferred Stock, par value $20 per share. This Participating Preferred Stock will have voting rights share for share with the Common Stock and will be non-cumulative, unless earned. It will be entitled

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to receive a prior preferred dividend of $1.00 per share in or for any year before the payment of any dividends on the Common Stock, in or for such year. After the Participating Preferred Stock shall have received a dividend of $1.00 per share in or for any one year it will not then be entitled to receive any further dividend in or for such year unless a dividend of $1.00 per share shall have been paid in or for such year on the Common Stock; after the Common Stock shall have received a dividend of $1.00 per share in or for such year, the Participating Preferred Stock will then be entitled to participate with the Common Stock in all further dividends paid in or for such year as follows: the amount of such further dividend per share of the Participating Preferred Stock shall be one and one-half times the amount of such further dividend per share of the Common Stock. Such Participating Preferred Stock shall be in a form, as to all of its terms, to be approved by or on behalf of all corporations parties to the Plan. Participating Preferred Stock shall be redeemable by Transportation Company at any time, in whole or in part, at the par value thereof.

(e) *Common Stock:*

A presently authorized issue of approximately 720,000 shares of Common Stock of no par value with voting rights share for share with the Participating Preferred Stock.

SECTION 4. *Distribution of Securities of Transportation Company.*

The present distribution of securities of Transportation Company will be as follows:

(a) To holders of stock and/or stock trust certificates of Class A, B and C Lessor Companies, outstanding in the hands of the public, approximately $31,974,000 face amount of 3%-6% Consolidated Mortgage Bonds. The precise amount of such 3%-6% Consolidated Mortgage Bonds to be issued in exchange for the stock and/or stock trust certificates of each Lessor Company is shown in

Schedule "D" attached.* These Bonds will be of the 3%-6% series maturing January 1, 2039 described in Section 3 (b) above.

(b) To holders of stock and/or stock trust certificates of Class A, B and C Lessor Companies, outstanding in the hands of the public, approximately 615,100 shares of Participating Preferred Stock of Transportation Company. The precise amount of such Participating Preferred Stock to be issued in exchange for the stock and/or stock trust certificates of each Lessor Company is shown in Schedule "D" attached.

(c) To holders of the 280,000 outstanding shares of 7% Cumulative Preferred Stock of P.R.T., 140,000 shares of Participating Preferred Stock of Transportation Company and 140,000 shares of Common Stock of Transportation Company.

(d) To holders of the 579,926 outstanding shares of Common Stock of P.R.T., 579,926 shares of Common Stock of Transportation Company.

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*In addition to the Consolidated Mortgage Bonds to be issued in exchange for stock and/or stock trust certificates of Lessor Companies as set forth in Schedule "D", and in addition to the Consolidated Mortgage Bonds to be issued in refunding outstanding bonds of Lessor Companies as set forth in Section 4 (f) below, there will also be issued: (1) to the Trustee of $523,000 face amount of Union Traction Company of Philadelphia 4% Sinking Fund Collateral Trust Mortgage Bonds due July 1, 1952, outstanding, in exchange for the existing collateral security therefor, $2,333,400 face amount of 3%-6% Consolidated Mortgage Bonds of Transportation Company due January 1, 2039 described in Section 3 (b); and (2) to the Trustee of $2,107,000 face amount of Philadelphia Rapid Transit Company 5% Collateral Bonds due February 1, 1957, outstanding, in exchange for the existing collateral security therefor, $9,476,700 face amount of said 3%-6% Consolidated Mortgage Bonds. These said additional Consolidated Mortgage Bonds, which will be in the total face amount of $11,810,100, will be owned by Transportation Company and not outstanding in the hands of the public but held by the Trustees for the aforesaid collateral trust bonds as collateral security therefor; the said two respective amounts of said Consolidated Mortgage Bonds are in such amount that the fixed interest thereon would equal the interest and sinking fund payments required by the indentures under which the aforesaid respective collateral trust bonds were issued. Such Consolidated Mortgage Bonds shall be cancelled upon the retirement of the said respective obligations which they will secure.

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(e) To holders of $1,897,860 face amount of outstanding bonds of Lessor Companies listed below, in exchange therefor, $1,897,860 face amount of the First and Refunding 4% Mortgage Bonds of Transportation Company, due January 1, 1969, described in section 3 (a) above:

	Face Amount Outstanding in Hands of Public
Darby & Yeadon Street Railway Company 4½% First Mortgage Bonds, due December 1, 1934	$200,000
Peoples Passenger Railway Company 4% First Mortgage Bonds, due January 15, 1935	219,000
Philadelphia City Passenger Railway Company 5% Debenture Bonds, due March 1, 1935	100,000
Empire Passenger Railway Company of Philadelphia 6% First Mortgage Bonds, due March 1, 1935	100,000*
Catherine and Bainbridge Streets Railway Company of the City of Philadelphia, The, 6% First Mortgage Bonds, due April 1, 1935	150,000
Frankford and Southwark Philadelphia City Passenger Railroad Company (West End Passenger Railway Company) 4% First Mortgage Bonds, due October 1, 1935	132,100
Hestonville, Mantua and Fairmount Passenger Railroad Company 5½% Consolidated Bonds, due May 1, 1934 and May 1, 1939	896,760
Seventeenth and Nineteenth Streets Passenger Railway Company of Philadelphia 6% First Mortgage Bonds, due July 1, 1939	100,000
TOTAL	$1,897,860*

*$100,000 face amount additional First and Refunding 4% Mortgage Bonds of Transportation Company will be issued to refund an additional $100,000 face amount of Empire Pass. Ry. Co. of Phila. 6% First Mtge. Bonds due March 1, 1935. Said additional First and Refunding Bonds will be owned by Transportation Company and not outstanding in the hands of the public but held by the Trustee of the sinking fund for the Phila. & Willow Grove St. Ry. Co. 4½% Mtge. Bonds due July 1, 1939; they will be cancelled when said obligations they will secure are retired.

(f) To holders of $1,491,000 face amount of the outstanding bonds of Lessor Companies listed below, in exchange therefor, $596,400 face amount of the 3%-6% Consolidated Mortgage Bonds of Transportation Company, due January 1, 2039, described in section 3 (b) above:

	Present Face Amount	*Face Amount of New Bonds to be Issued*
Darby, Media and Chester Street Railway Company 4½% First Mortgage Bonds, due July 1, 1936	$991,000	$396,400
Doylestown and Willow Grove Railway Company First Mortgage 4% Bonds, due June 1, 1960....	500,000	200,000
TOTAL.....	$1,491,000	$596,400

The totals of all classes of capital securities of, and of bonds, mortgages and ground rents on the property of, Transportation Company and/or its wholly-owned subsidiaries to be issued and outstanding in the hands of the public upon the effectuation of the Plan are shown in Schedule "E" attached. The amount thereof will be approximately $85,015,193.42.

SECTION 5. *Distribution of Cash.*

(a) The stock and stock trust certificates of Lessor Companies held by the public will be exchanged for the amounts of cash and securities of Transportation Company set forth in Schedule "D". The cash payments therefor will total approximately $2,204,000.

(b) The 7% Cumulative Preferred Stock of P.R.T. will be exchanged for cash and Participating Preferred Stock and Common Stock of Transportation Company as set forth in Section 6. The cash payments therefor will total $280,000.

(c) All claims incident to or arising out of the ordinary operation of the P.R.T. System whether founded in

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contract or in tort, and including taxes, will, under the Plan, be paid in due course in cash.

(d) Transportation Company shall assume liability for the payment of, and will pay in full in cash, all taxes legally due or which may become due to the United States of America, the Commonwealth of Pennsylvania, the City of Philadelphia and/or any other taxing authority by the Debtor, the Additional Debtors, the Trustees thereof, other merging companies and/or wholly-owned subsidiaries whether or not proofs of claim therefor have been filed in this reorganization proceeding (unless such taxes are fully paid and satisfied prior to the confirmation of this Second Revised Plan of Reorganization) and such taxes shall be assessed against, collected from, and paid by Transportation Company in the same manner and subject to the same provisions of law as would be applicable to the Debtor, the Additional Debtors, other merging companies and wholly-owned subsidiaries had this reorganization proceeding not intervened.

(e) Reasonable compensation for services rendered and reimbursement for the actual and necessary expenses incurred in connection with the reorganization proceedings and the Plan, as may be duly authorized and approved by the Court, shall be paid in cash.

(f) The balance of cash in the P.R.T. treasury will be turned into the treasury of Transportation Company and shall be applicable to its corporate purposes, except that said cash shall not be used for the payment of any dividends on any stock of Transportation Company.

(g) No further payments on account of rent or use and occupancy will be made unless ordered by the Court.

SECTION 6. *Modification of Rights of P.R.T. Stockholders.*

The holders of P.R.T. Preferred Stock will waive their right to receive all unpaid and accumulated divi-

dends and will convert their holdings of P.R.T. Preferred Stock one half into Participating Preferred Stock of Transportation Company and one half into Common Stock of Transportation Company, so that in place of 280,000 shares of P.R.T. Preferred Stock presently outstanding (of a par value of $50 per share) they will receive 140,000 shares of Participating Preferred Stock of Transportation Company of a par value of $20 per share and 140,000 shares of no par Common Stock of Transportation Company; and the holders of P.R.T. Preferred Stock will also receive $1 in cash for each share thereof at the time of said exchange. The P.R.T. Common Stockholders will convert their holdings of P.R.T. Common Stock, share for share, into no par Common Stock of Transportation Company.

SECTION 7. *Compromise of All Claims and Litigation and Classification of Claims of Creditors and Interests of Stockholders.*

This plan is proposed by P.R.T. as one to be accepted by all parties in interest in compromise of all claims of all kinds and of all pending litigation in the reorganization proceedings, either in the District Court or on appeal in the Circuit Court of Appeals. For the purposes of this Plan, therefore, the claims of creditors and the interests of stockholders of all corporations parties to the Plan are allowed and classified as follows,* the holders of each security of a different nature comprising a separate class:

* To comply with the technical requirements of the Federal Bankruptcy Act as amended, not only is stock of corporations parties to the Plan which is outstanding in the hands of the public classified but also stock of such corporations is classified even though it is (1) inter-company owned and held by P.R.T. as owner or lessee or (2) is pledged as collateral security for stock trust certificates which are also classified. There is no duplication in making the latter classifications for the holders of the stock trust certificates must be classified as creditors whereas the stock (which is held by the trustees of the issues of the stock trust certificates, and not by the stock trust certificate holders themselves) must also be classified to comply with the technical requirements of the Federal Bankruptcy Act as mentioned above; the holders of stock trust certificates will have no duplicate voting rights.

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(a) The following separate classes of holders of outstanding stock whose rights are modified or altered by the Plan:

	Total Shares Outstanding
(1) Philadelphia Rapid Transit Company—Preferred Stock	280,000
(2) Philadelphia Rapid Transit Company—Common Stock	579,926
(3) Catherine and Bainbridge Streets Railway Company of the City of Philadelphia, The	8,000
(4) Citizens Passenger Railway Company of Philadelphia	10,000
(5) Continental Passenger Railway Company of Philadelphia	20,000
(6) Empire Passenger Railway Company of Philadelphia	12,000
(7) Fairmount Park and Haddington Passenger Railway Company, The	6,000
(8) Frankford and Southwark Philadelphia City Passenger Railroad Company	37,500
(9) Germantown Passenger Railway Company	30,000
(10) Green and Coates Streets Philadelphia Passenger Railway Company	10,000
(11) Peoples Passenger Railway Company—Common Stock	60,000
(12) Peoples Passenger Railway Company—Preferred Stock	23,000
(13) Philadelphia City Passenger Railway Company	20,000
(14) Philadelphia and Darby Railway Company, The	4,000
(15) Philadelphia and Grays Ferry Passenger Railway Company	12,388
(16) Ridge Avenue Passenger Railway Company	15,000

	Total Shares Outstanding
(17) Second and Third Streets Passenger Railway Company of Philadelphia	21,204
(18) Seventeenth and Nineteenth Streets Passenger Railway Company of Philadelphia	10,000
(19) Thirteenth and Fifteenth Streets Passenger Railway Company of the City of Philadelphia	20,000
(20) Union Passenger Railway Company of Philadelphia	30,000
(21) West Philadelphia Passenger Railway Company	15,000
(22) Electric Traction Company of Philadelphia, The	175,000
(23) Peoples Traction Company	200,000
(24) Hestonville, Mantua and Fairmount Passenger Railroad Company — Common Stock	39,322
(25) Hestonville, Mantua and Fairmount Passenger Railroad Company — Preferred Stock	10,678
(26) Philadelphia Traction Company	400,000
(27) Union Traction Company of Philadelphia	600,000
(28) Darby, Media and Chester Street Railway Company	17,000
(29) Darby and Yeadon Street Railway Company	100
(30) Doylestown and Willow Grove Railway Company	10,000
(31) Philadelphia and Willow Grove Street Railway Company	2,016

The Plan is conditioned upon its acceptance by a majority in amount of each such class of outstanding stockholders.

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(b) The following separate classes of holders of outstanding bonds and stock trust certificates whose rights are modified or altered by the Plan:

	Face Amount Outstanding in Hands of Public
(32) Catherine and Bainbridge Streets Railway Company of the City of Philadelphia, The, First Mortgage 6% Bonds, due April 1, 1935	$150,000
(33) Darby, Media and Chester Street Railway Company First Mortgage 4½% Bonds, due July 1, 1936	991,000
(34) Darby and Yeadon Street Railway Company First Mortgage 4½% Bonds, due December 1, 1934	200,000
(35) Doylestown and Willow Grove Railway Company First Mortgage 4% Bonds, due June 1, 1960	500,000
(36) Empire Passenger Railway Company of Philadelphia 6% First Mortgage Bond, due March 1, 1935	100,000¶
(37) Frankford and Southwark Philadelphia City Passenger Railroad Company, (West End Passenger Railway Company) First Mortgage 4% Bonds, due October 1, 1935	132,100
(38) Hestonville, Mantua and Fairmount Passenger Railroad Company 5½% Consolidated Bonds, due May 1, 1934 and May 1, 1939	896,760
(39) Peoples Passenger Railway Company First Mortgage 4% Bonds, due January 15, 1935	219,000

¶ $100,000 face amount of additional Empire Pass. Ry. Co. of Phila. 6% 1st Mtge. Bonds, due March 1, 1935, held by the Trustee of the sinking fund for the Phila. & Willow Grove St. Ry. Co. 4½% Mtge. Bonds, due July 1, 1939, will be refunded with $100,000 face amount First and Refunding 4% Mortgage Bonds of Transportation Company which will be owned by Transportation Company and not outstanding in the hands of the public held by said sinking fund Trustee, and will be cancelled upon the retirement of said obligations which they will secure.

	Face Amount Outstanding in Hands of Public
(40) Philadelphia City Passenger Railway Company 5% Debenture Coupon Bonds, due March 1, 1935.....	$100,000
(41) Philadelphia Rapid Transit Company 5% Collateral Bonds, due February 1, 1957	2,107,000*†
(42) Philadelphia and Willow Grove Street Railway Company 4½% Mortgage Bonds, due July 1, 1939.....	363,300‡
(43) Seventeenth and Nineteenth Streets Passenger Railway Company of Philadelphia First Mortgage 6% Bonds, due July 1, 1939.....	100,000
(44) Union Traction Company of Philadelphia 4% Fifty Year Sinking Fund Collateral Trust Mortgage Bonds, due July 1, 1952.....	523,000§

*Estimated amount giving effect to estimated sinking fund retirements to January 1, 1939.

†These bonds are to remain outstanding, the collateral therefor to be exchanged for $9,476,700 face amount of 3%-6% Consolidated Mortgage Bonds of Transportation Company due January 1, 2039 described in Section 3 (b) above which will be owned by Transportation Company and not outstanding in the hands of the public but held by the Trustee for the P.R.T. Co. 5% Collateral Bonds, due February 1, 1957 and will be cancelled upon the retirement of said obligations which they will secure.

‡These bonds are to remain outstanding, some of the securities in the sinking fund therefor, viz., $100,000 face amount of Empire Pass. Ry. Co. of Phila., 6% 1st Mtge. Bonds, due Mar. 1, 1935 to be refunded with $100,000 face amount of First and Refunding 4% Mortgage Bonds of Transportation Company, as authorized in Section 3 (a) (i) above, $100,100 face amount of additional Phila. & Willow Grove St. Ry. Co. 4½% Mtge. Bonds, due July 1, 1939 are held by the Trustee of the said sinking fund for said bonds. The bonds in said sinking fund will be owned by Transportation Company and not outstanding in the hands of the public but held by said sinking fund Trustee, and will be cancelled upon the retirement of said obligations which they will secure.

§These bonds are to remain outstanding, the collateral therefor to be exchanged for $2,333,400 face amount of 3%-6% Consolidated Mortgage Bonds of Transportation Company due January 1, 2039 described in Section 3 (b) above which will be owned by Transportation Company and not outstanding in the hands of the public but held by the Trustee for the Union Trac. Co. of Phila. 4% 50 Year Sinking Fund Collateral Trust Mtge. Bonds, due July 1, 1952, and will be cancelled upon the retirement of said obligations which they will secure.

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	Face Amount Outstanding in Hands of Public
(45) Peoples Passenger Railway Stock Trust Certificates	$4,150,000
(46) Electric and Peoples Traction Stock Trust Certificates	29,606,264

The Plan is conditioned upon its approval by two-thirds in amount of each such class of creditors.

(c) The rights of the following class are not modified or altered by the Plan; they are the holders of the following claims against the corporations set forth below or against property owned by them:

Mortgage Bonds	*Face Amount Outstanding in Hands of Public*
Continental Passenger Railway Company of Philadelphia First Mortgage 4% Bonds, due July 1, 1959	$280,000
Frankford and Southwark Philadelphia City Passenger Railroad Company, (Lombard and South Street Passenger Railway Company) First Mortgage 3½% Bonds, due December 1, 1951	150,000
Market Street Elevated Passenger Railway Company First Mortgage 4% Bonds, due May 1, 1955	10,000,000
Peoples Passenger Railway Company Second Mortgage 4% Bonds, due July 15, 1961	285,000
Peoples Passenger Railway Company Consolidated Mortgage 4% Bonds, due March 1, 1962	246,000
Philadelphia City Passenger Railway Company First Mortgage 4% Bonds, due January 1, 1960	200,000

	Face Amount Outstanding in Hands of Public
Philadelphia and Darby Railway Company, The, First Mortgage 5¾% Bonds, due May 1, 1957	$100,000
Philadelphia Rapid Transit Company Fifty Year 5% and 6% Sinking Fund Bonds, due March 1, 1962 (Second Mortgage on Market Street Subway-Elevated)	7,859,000†
Thirteenth and Fifteenth Streets Passenger Railway Company of the City of Philadelphia 6% First Mortgage Bonds, due January 1, 1944	436,000
Union Passenger Railway Company of Philadelphia First Mortgage 4% Bonds, due March 31, 1961	500,000
Union Passenger Railway Company of Philadelphia Second Mortgage 4% Bonds, due March 31, 1960	250,000
West Philadelphia Passenger Railway Company First Mortgage 3½% Bonds, due April 1, 1956	246,000
West Philadelphia Passenger Railway Company Second Mortgage 5½% Bonds, due May 1, 1956	750,000

Real Estate Mortgage Bonds	*Face Amount*
Motor Real Estate Company — Philadelphia Rapid Transit Company Real Estate First Mortgage 6% Bonds of C. Benton Cooper, due Jan. 1, 1944	$1,847,500*

* Estimated amount giving effect to estimated sinking fund retirements to January 1, 1939.

† $283,000 face amount additional P.R.T. Co. 50 Year 6% Sinking Fund Bonds due Mar. 1, 1962 will be owned by Transportation Company and not outstanding in the hands of the public but held by the Trustee of the sinking fund for the Phila. & Willow Grove St. Ry. Co. 4½% Mtge. Bonds due July 1, 1939; they will be cancelled when said obligations they will secure are retired.

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Real Estate Mortgages on following properties of Companies listed below

Motor Real Estate Company:	
Blanket Mortgage—Metropolitan Life Insurance Co.	$1,320,000
Rising Sun Ave. & Knorr St.	4,000
Venango, Wissahickon & Hunting Park Ave.	35,000
Mill Road, Upper Darby, Pa.	125,000
2nd & Erie Ave.	10,000
Penn & Comly Sts.	43,000
Front & Chew Sts.	246,157
251-53 S. 15th Street	65,000
Peoples Passenger Railway Company	
Pier 34 and East side Beach St.	62,600
Philadelphia Traction Company	
13th & Mt. Vernon Sts.	75,000
Union Traction Company of Philadelphia	
6739 Germantown Ave.	10,000

Ground Rents on the following properties of Companies listed below ¶

Electric Traction Company of Philadelphia	
Penn St.—So. of Laurel St.	$1,254
Frankford & Southwark Philadelphia City Passenger Railroad Company	
25th & South Sts.	5,010
25th & Lombard Sts.	2,500
Germantown Passenger Railway Company	
Taney St. No. of Poplar St.	3,347
27th & Poplar Sts.	733
2603 Poplar Street	10,000
Philadelphia City Passenger Railway Company	
Belmont Ave. & Jefferson St.	35,000
Philadelphia Traction Company	
Schuylkill Ave. So. of United States Naval Home	50,000
Real Estate Holding Company	
8 S. 33rd Street	333

¶ Ground rents which do not have a stated principal amount for redemption thereof are stated at an amount which represents a capitalization of the annual payments on a 6% basis.

SECTION 8. *City-Company Relationships.*

The Plan is conditioned upon the extension of the term of the Broad Street Subway System Lease to July 1, 1957. City action necessary to effect the foregoing and to evidence the City's necessary consents under the City-Company contract of July 1, 1907 will be seasonably sought.

SECTION 9. *Further Provisions of the Plan.*

(a) No executory contracts will be rejected under the Plan. Certain contracts, including the old leases and other inter-company contracts, will be terminated or revised by mutual consent in the formation by merger of Transportation Company.

(b) Reasonable compensation for services rendered and reimbursement for the actual and necessary expenses incurred in connection with the reorganization proceedings and the Plan, as may be duly authorized and approved by the Court, shall be paid in cash by Transportation Company.

(c) All claims incident to or arising out of the ordinary operation of the P.R.T. System, whether founded in contract or in tort, and including taxes, will, under the Plan, be paid in due course in cash.

(d) Under "The Contract of 1907" entered into between the City of Philadelphia and P.R.T. as of July 1, 1907, pursuant to Ordinance of City Council, the consent of the City, given by Ordinance of City Council, will be necessary to enable P.R.T. to take such steps as are necessary for the Plan to be consummated. Such consent will be seasonably sought.

(e) The plan will require prior approval by the Pennsylvania Public Utility Commission. Such approval will be seasonably sought.

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(f) Securities of Transportation Company will be exchanged, as set forth above, for the presently existing securities, against delivery of the latter by the holders thereof. In making said exchanges with each individual holder, bonds of less than $100 face amount and fractions of shares of Participating Preferred Stock or of Common Stock will not be issued; where a holder is entitled, whether or not in addition to whole pieces, to less than $100 in bonds and less than one share of stock, he will be issued scrip for such fractions of bonds or stock. Scrip for bonds will be issued only in amounts of one dollar or multiples thereof; and will be issued in such respective amounts as will be to the nearest dollar to which each individual holder will be entitled; that is to say, amounts from one to forty-nine cents will be dropped and for amounts of fifty to ninety-nine cents scrip for a whole dollar will be issued. Scrip for Participating Preferred Stock will be issued only in fractions of one twentieth of a share or multiples thereof; and will be issued in such respective amounts as will be to the nearest twentieth of a share to which each individual holder will be entitled; that is to say, amounts up to one-half of one twentieth of a share will be dropped and for amounts of one-half or more of one twentieth of a share scrip for a whole one twentieth of a share will be issued. Scrip for Common Stock will be issued only in fractions of one-half of a share, this being the only fraction involved in the case of Common Stock. No interest will be paid on scrip for bonds and said scrip will not be deemed to be bonds and the holders thereof will not be deemed to be bondholders or to have any of the rights thereof, until said scrip is converted into bonds. Scrip for bonds will be converted into bonds of not less than $100 face amount against delivery of scrip in sufficient amounts. No dividends will be paid on scrip for Participating Preferred Stock or Common Stock, and said scrip will not be deemed to be stock and the holders thereof will not be deemed to be stockholders or to have any of the rights thereof, until said

scrip is converted into stock certificates for whole shares. Scrip for stock will be converted into stock certificates for whole shares against delivery of scrip in sufficient amounts. Such conversion of scrip for bonds or stock must be made on or before December 31, 1943 and after said date all unconverted scrip will be void and of no value whatever.

(g) The execution of the Plan shall be carried out in the manner set forth in the Plan and pursuant to the provisions of the Federal Bankruptcy Act. Reorganization managers may be appointed with the approval of the Court. The detailed means and methods to be taken to present the Plan to the security holders who will be entitled to vote thereon, and of obtaining the necessary acceptances, consents and approvals of the Plan to secure its confirmation and consummation, shall be determined, subject to the provisions of the Plan and of the Federal Bankruptcy Act, by such reorganization managers and they shall take or cause to be taken such steps and action as they shall so determine to be necessary or desirable to secure the required acceptances, consents, approvals and confirmation of the Plan and in order to carry out the Plan after its confirmation. The form of all new securities to be issued under the Plan, and of all instruments and documents contemplated thereby or necessary or proper in connection therewith, shall be determined with the approval of the reorganization managers, subject to such final approvals as are requisite under the provisions of the Plan and of the Federal Bankruptcy Act. All steps taken shall be subject to such approval of the Court as may be required. The reorganization managers shall endeavor to carry out the reorganization in accordance with the Plan and subject to the supervision of the Court, but shall not assume any personal liability in connection with carrying out the Plan, except to exercise good faith in such endeavor.

(h) The reorganization of the corporations parties to the Plan shall, upon final approval and confirmation, be and become effective as of January 1, 1939.

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SCHEDULE "A"

COMPANIES TO MERGE IN ADDITION TO PARTIES TO THE PLAN.

Companies, all the stock of which is owned by P.R.T.:

Broad Street and Boulevard Street Railway Company,
Broad Street Rapid Transit Street Railway Company,
Bustleton and Byberry Rapid Transit Street Railway Company,
Cayuga and Torresdale Street Railway Company,
Champlost Street Connecting Railway Company,
Frankford Connecting Railway Company,
Germantown Loop Railway Company,
Glenwood Rapid Transit Street Railway Company,
Mount Vernon, Shawmont and Roxborough Street Railway Company,
Moyamensing and Southwark Rapid Transit Street Railway Company,
Parkside Rapid Transit Street Railway Company,
Pelham and Frankford Street Railway Company,
Sansom Street Connecting Railway Company,
Tioga and Frankford Street Railway Company,
Wayne Junction Connecting Railway Company.

Companies, all the stock of which is owned by Union Traction Company of Philadelphia:

Aramingo Avenue Passenger Railway Company, The,
Beach Street Connecting Railway Company,
Brown and Parrish Street Railway Company, The,
Centennial Passenger Railway Company, The,
Citizens Clearfield and Cambria Street Railway Company, The,
Citizens East End Street Railway Company, The,
Citizens North End Street Railway Company, The,
East Aramingo Avenue Passenger Railway Company, The,
Girard Avenue Passenger Railway Company, The,

Hillcrest Avenue Passenger Railway Company,
Lehigh Avenue Railway Company of Philadelphia,
Northern Passenger Railway Company, The,
Philadelphia, Cheltenham and Jenkintown Passenger Railway Company, The,
Snyder Avenue Railway Company.

Companies, all the stock of which is owned as follows:

Fairmount Park Railway Company, The
(100% owned by Thirteenth and Fifteenth Streets Passenger Railway Company),
Huntingdon Street Connecting Passenger Railway Company
(100% owned by Philadelphia Traction Company),
Kessler Street Connecting Passenger Railway Company
(100% owned by Philadelphia Traction Company),
Park Avenue and Carlisle Street Passenger Railway Company of Philadelphia, The
(100% owned by Thirteenth and Fifteenth Streets Passenger Railway Company),
Ridge Avenue Connecting Railway Company
(100% owned by Philadelphia Traction Company),
Tioga and Venango Streets Passenger Railway Company of Philadelphia, The
(100% owned by Thirteenth and Fifteenth Streets Passenger Railway Company),
Twenty-Second Street and Allegheny Avenue Passenger Railway Company
(89% owned by Philadelphia Traction Company, 11% owned by Union Traction Company of Philadelphia),
Walnut Street Connecting Passenger Railway Company of the City of Philadelphia, The
(100% owned by Philadelphia Traction Company).

NOTE: As a part of the Plan, and either prior to or subsequent to said merger, all of the corporate powers,

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franchises, property, rights and credits of Philadelphia Rural Transit Company and Pennsylvania Rapid Transit Company will be acquired by P.R.T. or its successor, Transportation Company, and those of D M & C Bus Company will be acquired by Darby, Media and Chester Street Railway Company or its successor, Transportation Company, as set forth in Section 2 above.

SCHEDULE "B"

COMPANIES NOT TO BE MERGED, ALL THE STOCK OF WHICH EXCEPT AS NOTED WILL BE OWNED BY TRANSPORTATION COMPANY.

Chester and Philadelphia Railway Company (51 per cent. of stock will be owned by Transportation Company),
Market Street Elevated Passenger Railway Company,
Motor Real Estate Company,
Real Estate Holding Company,
Willow Grove Park Company.

SCHEDULE "C"

PRIOR LIEN BONDS, MORTGAGES AND GROUND RENTS TO REMAIN OUTSTANDING AND WHICH MAY BE LATER REFUNDED BY THE ISSUE OF PHILADELPHIA TRANSPORTATION COMPANY BONDS.

Continental Passenger Railway Company of Philadelphia First Mortgage 4% Bonds, due July 1, 1959	$280,000
Frankford & Southwark Philadelphia City Passenger Railroad Company, (Lombard & South Street Passenger Railway Company) First Mortgage 3½% Bonds, due December 1, 1951	150,000
Market Street Elevated Passenger Railway Company First Mortgage 4% Bonds, due May 1, 1955	10,000,000

Peoples Passenger Railway Company Second Mortgage 4% Bonds, due July 15, 1961	$285,000
Peoples Passenger Railway Company consolidated Mortgage 4% Bonds, due March 1, 1962	246,000
Philadelphia City Passenger Railway Company First Mortgage 4% Bonds, due January 1, 1960	200,000
Philadelphia & Darby Railway Company, The, First Mortgage 5¾% Bonds, due May 1, 1957	100,000
Philadelphia Rapid Transit Company 5% Collateral Bonds, due February 1, 1957	2,107,000*
Philadelphia Rapid Transit Company 50 Year 5% and 6% Sinking Fund Bonds, due March 1, 1962 (Second Mortgage on Market Street Subway-Elevated)	7,859,000†
Philadelphia and Willow Grove Street Railway Company 4½% Mortgage Bonds, due July 1, 1939	363,300†
Thirteenth and Fifteenth Streets Passenger Railway Company of the City of Philadelphia 6% First Mortgage Bonds, due January 1, 1944	436,000
Union Passenger Railway Company of Philadelphia First Mortgage 4% Bonds, due March 31, 1961	500,000
Union Passenger Railway Company of Philadelphia Second Mortgage 4% Bonds, due March 31, 1960	250,000
Union Traction Company of Philadelphia 4% 50 Year Sinking Fund Collateral Trust Mortgage Bonds, due July 31, 1952	523,000
West Philadelphia Passenger Railway Company First Mortgage 3½% Bonds, due April 1, 1956	246,000

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West Philadelphia Passenger Railway Company Second Mortgage 5½% Bonds, due May 1, 1956	$750,000
Real Estate Mortgage Bonds and Miscellaneous Real Estate Mortgages and Ground Rents (Schedule E-1)	3,951,435
TOTAL	$28,246,735*†

*Estimated amount giving effect to estimated sinking fund retirements to January 1, 1939.

†$283,000 face amount additional P.R.T. 50 Year 6% Sinking Fund Bonds due Mar. 1, 1962 and $100,100 face amount additional Phila. & Willow Grove St. Ry. Co. 4½% Mtge. Bonds due July 1, 1939 will be owned by Transportation Company and not outstanding in the hands of the public but held by the Trustee of the sinking fund for said Phila. & Willow Grove St. Ry. Co. Bonds; they will be cancelled when said obligations they will secure are retired.

SCHEDULE "D"

DISTRIBUTION OF SECURITIES OF PHILADELPHIA TRANSPORTATION COMPANY AND CASH TO BE ISSUED IN E
OF LESSOR COMPANIES OUTSTANDING IN THE HANDS OF THE

NEW SECURITIES* AND CASH TO BE RECEIVED IN EXCHANGE FOR OLD STOCK AND STOCK TRUST CERTIFIC

CLASS "A"	Old Shares or Stk. Tr. Ctfs. Outstanding in Hands of Public	Securities: 3⅞-6% Consolidated Mortgage Bonds — Face Value: Total	3⅞-6% Consolidated Mortgage Bonds — Face Value: Per Old Share or Stk Tr Ctf	Participating Preferred Stock‡ — Shares: Total	Participating Preferred Stock‡ — Shares: Per Old Share or Stk Tr Ctf	Participating Preferred Stock‡ — Par Value: Total	Participating Preferred Stock‡ — Par Value: Per Old Share or Stk Tr Ctf	Total Face and Par Value of New Securities: Total	Total Face and Par Value of New Securities: Per Old Share or Stk Tr Ctf	T C
Citizens Passenger Railway Co. of Philadelphia	10,000	$1,008,500.00	$100.85	8,450.0	0.845	$169,000.00	$16.90	$1,177,500.00	$117.75	$
Continental Passenger Railway Co. of Philadelphia	20,000	749,200.00	37.46	6,270.0	0.3135	125,400.00	6.27	874,600.00	43.73	
Fairmount Park & Haddington Passenger Railway Co., The	6,000	129,660.00	21.61	1,086.0	0.181	21,720.00	3.62	151,380.00	25.23	
Frankford & Southwark Philadelphia City Passenger Railroad Co.	37,500	4,862,625.00	129.67	40,725.0	1.086	814,500.00	21.72	5,677,125.00	151.39	1
Germantown Passenger Railway Co.	30,000	1,134,600.00	37.82	9,495.0	0.3165	189,900.00	6.33	1,324,500.00	44.15	
Green & Coates Streets Philadelphia Passenger Railway Co.	10,000	432,300.00	43.23	3,620.0	0.362	72,400.00	7.24	504,700.00	50.47	
Philadelphia City Passenger Railway Co.	19,919	1,076,223.57	54.03	9,003.4	0.452	180,068.00	9.04	1,256,291.57	63.07	
Philadelphia & Darby Railway Co., The	3,295	39,408.20	11.96	329.5	0.1	6,590.00	2.00	45,998.20	13.96	
Philadelphia & Grays Perry Passenger Railway Co.	12,296	354,370.72	28.82	2,963.3	0.241	59,266.00	4.82	413,636.72	33.64	
Ridge Avenue Passenger Railway Co.	15,000	1,296,750.00	86.45	10,852.5	0.7235	217,050.00	14.47	1,513,800.00	100.92	
Second & Third Streets Passenger Railway Co. of Philadelphia	21,204	1,833,085.80	86.45	15,341.1	0.7235	306,822.00	14.47	2,139,907.80	100.92	
Thirteenth & Fifteenth Sts. Passenger Railway Co. of the City of Philadelphia	19,950	1,724,677.50	86.45	14,433.8	0.7235	288,676.00	14.47	2,013,353.50	100.92	
Union Passenger Railway Co. of Philadelphia	23,954	1,416,879.10	59.15	11,857.2	0.495	237,144.00	9.90	1,654,023.10	69.05	
West Philadelphia Passenger Railway Co.	7,141	445,027.12	62.32	3,724.0	0.5215	74,480.00	10.43	519,507.12	72.75	
Peoples Passenger Railway Co. Stock Trust Certificates	4,150-A	1,195,864.00	288.16	10,016.0	2.4135	200,320.00	48.27	1,396,184.00	336.43	
Total Class "A"	.....	$17,699,171.01	.....	148,166.8	.....	$2,963,336.00	.....	$20,662,507.01	.....	$
CLASS "B"										
Hestonville, Mantua & Fairmount Passenger Railroad										

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SCHEDULE "D"

RANSPORTATION COMPANY AND CASH TO BE ISSUED IN EXCHANGE FOR STOCK AND STOCK TRUST CERTIFICATES
LESSOR COMPANIES OUTSTANDING IN THE HANDS OF THE PUBLIC

CASH TO BE RECEIVED IN EXCHANGE FOR OLD STOCK AND STOCK TRUST CERTIFICATES

Securities					Cash		Annual Return on 3%-6% Consolidated Mortgage Bonds†				Participating Preferred Stock
Participating Preferred Stock‡			Total Face and Par Value of New Securities				3% (Fixed)		6% (Maximum) (Additional 3% if earned)		
hares	Par Value										Preference Dividend (if earned)
Per Old Share or Stk Tr Ctf	Total	Per Old Share or Stk Tr Ctf	Total	Per Old Share or Stk Tr Ctf	Total Cash	Cash Per Old Share or Stk Tr Ctf	Total	Per Old Share or Stk Tr Ctf	Total	Per Old Share or Stk Tr Ctf	Per Old Share or Stk Tr Ctf‡
0.845	$169,000.00	$16.90	$1,177,500.00	$117.75	$35,000.00	$3.50	$30,255.00	$3.03	$60,510.00	$6.05	$0.85
0.3135	125,400.00	6.27	874,600.00	43.73	26,000.00	1.30	22,476.00	1.12	44,952.00	2.25	.31
0.181	21,720.00	3.62	151,380.00	25.23	3,000.00	.50	3,889.80	.65	7,779.60	1.30	.18
1.086	814,500.00	21.72	5,677,125.00	151.39	168,750.00	4.50	145,878.75	3.89	291,757.50	7.78	1.09
0.3165	189,900.00	6.33	1,324,500.00	44.15	39,300.00	1.31	34,038.00	1.13	68,076.00	2.27	.32
0.362	72,400.00	7.24	504,700.00	50.47	15,000.00	1.50	12,969.00	1.30	25,938.00	2.59	.36
0.452	180,068.00	9.04	1,256,291.57	63.07	37,447.72	1.88	32,286.71	1.62	64,573.41	3.24	.45
0.1	6,590.00	2.00	45,998.20	13.96	1,383.90	.42	1,182.25	.36	2,364.49	.72	.10
0.241	59,266.00	4.82	413,636.72	33.64	12,296.00	1.00	10,631.12	.86	21,262.24	1.73	.24
0.7235	217,050.00	14.47	1,513,800.00	100.92	15,000.00	1.00	38,902.50	2.59	77,805.00	5.19	.72
0.7235	306,822.00	14.47	2,139,907.80	100.92	63,612.00	3.00	54,992.57	2.59	109,985.15	5.19	.72
0.7235	288,676.00	14.47	2,013,353.50	100.92	59,850.00	3.00	51,740.33	2.59	103,480.65	5.19	.72
0.495	237,144.00	9.90	1,654,023.10	69.05	49,105.70	2.05	42,506.37	1.77	85,012.75	3.55	.50
0.5215	74,480.00	10.43	519,507.12	72.75	15,424.56	2.16	13,350.81	1.87	26,701.63	3.74	.52
2.4135	200,320.00	48.27	1,396,184.00	336.43	27,680.50	6.67	35,875.92	8.64	71,751.84	17.29	2.41
.....	$2,963,336.00	.....	$20,662,507.01	.....	$568,850.38	.....	$530,975.13	.....	$1,061,950.26	.....	.....
0.207	$16,676.00	$4.14	$50,591.76	$12.56	$2,014.00	$0.50	$1,017.47	$0.25	$2,034.95	$0.51	$0.21
0.3115	36,744.00	6.23	111,353.70	18.88	4,423.50	.75	2,238.29	.38	4,476.58	.76	.31
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

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Class "A"	Old Shares or Stk. Tr. Ctfs. Outstanding in Hands of Public	Face Value		Shares		Par Value			
		Total	Per Old Share or Stk Tr Ctf	Total	Per Old Share or Stk Tr Ctf	Total	Per Old Share or Stk Tr Ctf	Total	Per Old Share or Stk Tr Ctf
Citizens Passenger Railway Co. of Philadelphia	10,000	$1,008,500.00	$100.85	8,450.0	0.845	$169,000.00	$16.90	$1,177,500.00	$117.75
Continental Passenger Railway Co. of Philadelphia	20,000	749,200.00	37.46	6,270.0	0.3135	125,400.00	6.27	874,600.00	43.73
Fairmount Park & Haddington Passenger Railway Co., The	6,000	129,660.00	21.61	1,086.0	0.181	21,720.00	3.62	151,380.00	25.23
Frankford & Southwark Philadelphia City Passenger Railroad Co.	37,500	4,862,625.00	129.67	40,725.0	1.086	814,500.00	21.72	5,677,125.00	151.39
Germantown Passenger Railway Co.	30,000	1,134,600.00	37.82	9,495.0	0.3165	189,900.00	6.33	1,324,500.00	44.15
Green & Coates Streets Philadelphia Passenger Railway Co.	10,000	432,300.00	43.23	3,620.0	0.362	72,400.00	7.24	504,700.00	50.47
Philadelphia City Passenger Railway Co.	19,919	1,076,223.57	54.03	9,003.4	0.452	180,068.00	9.04	1,256,291.57	63.07
Philadelphia & Darby Railway Co., The	3,295	39,408.20	11.96	329.5	0.1	6,590.00	2.00	45,998.20	13.96
Philadelphia & Grays Ferry Passenger Railway Co.	12,296	354,370.72	28.82	2,963.3	0.241	59,266.00	4.82	413,636.72	33.64
Ridge Avenue Passenger Railway Co.	15,000	1,296,750.00	86.45	10,852.5	0.7235	217,050.00	14.47	1,513,800.00	100.92
Second & Third Streets Passenger Railway Co. of Philadelphia	21,204	1,833,085.80	86.45	15,341.1	0.7235	306,822.00	14.47	2,139,907.80	100.92
Thirteenth & Fifteenth Sts. Passenger Railway Co. of the City of Philadelphia	19,950	1,724,677.50	86.45	14,433.8	0.7235	288,676.00	14.47	2,013,353.50	100.92
Union Passenger Railway Co. of Philadelphia	23,954	1,416,879.10	59.15	11,857.2	0.495	237,144.00	9.90	1,654,023.10	69.05
West Philadelphia Passenger Railway Co.	7,141	445,027.12	62.32	3,724.0	0.5215	74,480.00	10.43	519,507.12	72.75
Peoples Passenger Railway Co. Stock Trust Certificates	4,150-A	1,195,864.00	288.16	10,016.0	2.4135	200,320.00	48.27	1,396,184.00	336.43
Total Class "A"	.....	$17,699,171.01	.....	148,166.8	.....	$2,963,336.00	.....	$20,662,507.01	.....
Class "B"									
Hestonville, Mantua & Fairmount Passenger Railroad Co.:									
Common	4,028	$33,915.76	$8.42	833.8	0.207	$16,676.00	$4.14	$50,591.76	$12.56
Preferred	5,898	74,609.70	12.65	1,837.2	0.3115	36,744.00	6.23	111,353.70	18.88
Philadelphia Traction Co.	400,000	6,728,000.00	16.82	166,000.0	0.415	3,320,000.00	8.30	10,048,000.00	25.12
Electric & Peoples Traction Stock Trust Certificates	29,606-B	4,980,365.73	168.22	122,777.2	4.147	2,455,544.00	82.94	7,435,909.73	251.16
Total Class "B"	.....	$11,816,891.19	.....	291,448.2	.....	$5,828,964.00	.....	$17,645,855.19	.....
Class "C"									
Union Traction Co. of Philadelphia	598,979	$2,407,895.58	$4.02	171,907.0	0.287	$3,438,140.00	$5.74	$5,846,035.58	$9.76
Darby, Media & Chester Street Railway Co.	17,000	49,640.00	2.92	3,544.5	0.2085	70,890.00	4.17	120,530.00	7.09
Total Class "C"	.....	$2,457,535.58	.....	175,451.5	.....	$3,509,030.00	.....	$5,966,565.58	.....
Summary Totals	.....	$31,973,597.78	.....	615,066.5	.....	$12,301,330.00	.....	$44,274,927.78	.....

NOTES: A—$1,000 Peoples Passenger Railway Stock Trust Certificates.
B—$1,000 Electric and Peoples Traction Stock Trust Certificates.
*—See Section 9 (f) as to fractions.
†—See Section 3 (d) as to return on new Participating Preferred Stock.
‡—See Section 3 (b) as to interest on Consolidated Mortgage Bonds.

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Securities					Cash		Annual Return on 3%-6% Consolidated Mortgage Bonds†				Participating Preferred Stock
Participating Preferred Stock‡			Total Face and Par Value of New Securities				3% (Fixed)		6% (Maximum) (Additional 3% if earned)		
hares	Par Value										Preference Dividend (if earned)
Per Old Share or Stk Tr Ctf	Total	Per Old Share or Stk Tr Ctf	Total	Per Old Share or Stk Tr Ctf	Total Cash	Cash Per Old Share or Stk Tr Ctf	Total	Per Old Share or Stk Tr Ctf	Total	Per Old Share or Stk Tr Ctf	Per Old Share or Stk Tr Ctf‡
0.845	$169,000.00	$16.90	$1,177,500.00	$117.75	$35,000.00	$3.50	$30,255.00	$3.03	$60,510.00	$6.05	$0.85
0.3135	125,400.00	6.27	874,600.00	43.73	26,000.00	1.30	22,476.00	1.12	44,952.00	2.25	.31
0.181	21,720.00	3.62	151,380.00	25.23	3,000.00	.50	3,889.80	.65	7,779.60	1.30	.18
1.086	814,500.00	21.72	5,677,125.00	151.39	168,750.00	4.50	145,878.75	3.89	291,757.50	7.78	1.09
0.3165	189,900.00	6.33	1,324,500.00	44.15	39,300.00	1.31	34,038.00	1.13	68,076.00	2.27	.32
0.362	72,400.00	7.24	504,700.00	50.47	15,000.00	1.50	12,969.00	1.30	25,938.00	2.59	.36
0.452	180,068.00	9.04	1,256,291.57	63.07	37,447.72	1.88	32,286.71	1.62	64,573.41	3.24	.45
0.1	6,590.00	2.00	45,998.20	13.96	1,383.90	.42	1,182.25	.36	2,364.49	.72	.10
0.241	59,266.00	4.82	413,636.72	33.64	12,296.00	1.00	10,631.12	.86	21,262.24	1.73	.24
0.7235	217,050.00	14.47	1,513,800.00	100.92	15,000.00	1.00	38,902.50	2.59	77,805.00	5.19	.72
0.7235	306,822.00	14.47	2,139,907.80	100.92	63,612.00	3.00	54,992.57	2.59	109,985.15	5.19	.72
0.7235	288,676.00	14.47	2,013,353.50	100.92	59,850.00	3.00	51,740.33	2.59	103,480.65	5.19	.72
0.495	237,144.00	9.90	1,654,023.10	69.05	49,105.70	2.05	42,506.37	1.77	85,012.75	3.55	.50
0.5215	74,480.00	10.43	519,507.12	72.75	15,424.56	2.16	13,350.81	1.87	26,701.63	3.74	.52
2.4135	200,320.00	48.27	1,396,184.00	336.43	27,680.50	6.67	35,875.92	8.64	71,751.84	17.29	2.41
.....	$2,963,336.00	.....	$20,662,507.01	.....	$568,850.38	.....	$530,975.13	.....	$1,061,950.26	.....	.....
0.207	$16,676.00	$4.14	$50,591.76	$12.56	$2,014.00	$0.50	$1,017.47	$0.25	$2,034.95	$0.51	$0.21
0.3115	36,744.00	6.23	111,353.70	18.88	4,423.50	.75	2,238.29	.38	4,476.58	.76	.31
0.415	3,320,000.00	8.30	10,048,000.00	25.12	800,000.00	2.00	201,840.00	.50	403,680.00	1.01	.42
4.147	2,455,544.00	82.94	7,435,909.73	251.16	592,125.28	20.00	149,410.97	5.05	298,821.94	10.09	4.15
.....	$5,828,964.00	.....	$17,645,855.19	.....	$1,398,562.78	.....	$354,506.73	.....	$709,013.47	.....	.....
0.287	$3,438,140.00	$5.74	$5,846,035.58	$9.76	$227,612.02	$0.38	$72,236.87	$0.12	$144,473.74	$0.24	$0.29
0.2085	70,890.00	4.17	120,530.00	7.09	9,180.00	.54	1,489.20	.09	2,978.40	.18	.21
.....	$3,509,030.00	.....	$5,966,565.58	.....	$236,792.02	.....	$73,726.07	.....	$147,452.14	.....	.....
.....	$12,301,330.00	.....	$44,274,927.78	.....	$2,204,205.18	.....	$959,207.93	.....	$1,918,415.87	.....	.....

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SCHEDULE "E"

CAPITAL SECURITIES TO BE OUTSTANDING UPON EFFECTUATION OF THE PLAN.

Real Estate Mortgage Bonds and Miscellaneous Real Estate Mortgages and Ground Rents	Schedule E-1		$3,951,435.64
Collateral Trust Bonds	Schedule E-2		2,630,000.00
Divisional Lien Bonds	Schedule E-3		21,665,300.00*
Philadelphia Transportation Company First and Refunding Mortgage 4% Bonds	Schedule E-4		1,897,860.00*
Philadelphia Transportation Company 3%-6% Consolidated Mortgage Bonds	Schedule E-5		
For stock and stock trust certificates of Lessor Companies		$31,973,597.78	
For refunding certain bonds of Lessor Companies		596,400.00	
			32,569,997.78†
			$62,714,593.52
Philadelphia Transportation Company Participating Preferred Stock (755,067 shares, par value $20 per share)			$15,101,340.00
Philadelphia Transportation Company Common Stock (719,926 shares, no par value, with a stated value of $10 per share)			7,199,260.00
			$22,300,600.00
TOTAL			$85,015,193.42*†

*$383,100 face amount additional Divisional Lien Bonds and $100,000 face amount additional First and Refunding 4% Mortgage Bonds will be owned by Transportation Company and not outstanding in the hands of the public but held by the Trustee of the sinking fund for the Phila. & Willow Grove St. Ry. Co. 4½% Mtge. Bonds, due uly 1, 1939; they will be cancelled when said obligations they will secure are retired.

†$11,810,100 face amount additional 3%-6% Consolidated Mortgage Bonds will be issued in exchange of collateral security for the collateral trust bonds listed in Echedule "E-2"; said additional Consolidated Mortgage Bonds will be owned by Transportation Company and not outstanding in the hands of the public but held by the Trustee of said collateral trust bonds; they will be cancelled when the obligations they will secure are retired.

SCHEDULE "E-1"

REAL ESTATE MORTGAGE BONDS AND MISCELLANEOUS REAL ESTATE MORTGAGES AND GROUND RENTS OUTSTANDING JANUARY 1, 1939, ON PROPERTY OF COMPANIES MENTIONED BELOW.

Company	*Due*	*Interest Rate*	*Amount*
Real Estate Mortgage Bonds			
Motor Real Estate Company			
Philadelphia Rapid Transit Company Real Estate First Mortgage 6% Bonds of C. Benton Cooper	Jan. 1, 1944	6%	$1,847,500.00*
Real Estate Mortgages			
Motor Real Estate Company			
Blanket Mortgage—Metropolitan Life Insurance Co.	Mar. 1, 1951	6	$1,320,000.00
Rising Sun Ave. & Knorr St.	Overdue	6	4,000.00
Venango, Wissahickon & Hunting Park Ave.	Overdue	6	35,000.00
Mill Road, Upper Darby, Pa.	Overdue	6	125,000.00
2nd & Erie Ave.	Dec. 13, 1940	4.5	10,000.00
Penn & Comly Sts.	Callable on 3 mo. notice	6	43,000.00
Front & Chew Sts.	Overdue	6	246,157.00
251-53 S. 15th Street	Overdue	5.5	65,000.00
Peoples Passenger Railway Company			
Pier 34 and E. side Beach St.	Overdue	6	62,600.00
Philadelphia Traction Company			
13th & Mt. Vernon Sts.	Overdue	6	75,000.00
Union Traction Company of Philadelphia			
6739 Germantown Ave.	Overdue	6	10,000.00
TOTAL MORTGAGES			$1,995,757.00
Ground Rents¶			
Electric Traction Company of Philadelphia			
Penn St.—S. of Laurel St.	.....	6	$1,254.16
Frankford & Southwark Philadelphia City Passenger Railroad Company			
25th & South Sts.	.....	6	5,010.00
25th & Lombard Sts.	.....	6	2,500.00

* Estimated amount giving effect to estimated sinking fund returements to January 1, 1939.

¶ Ground rents which do not have a stated principal amount for redemption thereof are stated at an amount which represent a capitalization of the annual payments on a 6% basis.

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Ground Rents¶			
Germantown Passenger Railway Company			
Taney St. No. of Poplar St.	.....	6	$3,347.80
27th & Poplar Sts.	.....	6	733.34
2603 Poplar Street	.....	5	10,000.00
Philadelphia City Passenger Railway Company			
Belmont Ave. & Jefferson St.	Sept. 1, 1939	4	35,000.00
Philadelphia Traction Company			
Schuylkill Ave. So. of United States Naval Home	.....	5	50,000.00
Real Estate Holding Company			
8 S. 33rd Street	.....	6	333.34
TOTAL GROUND RENTS			$108,178.64
TOTAL			$3,951,435.64*

SCHEDULE "E-2"

COLLATERAL TRUST BONDS OUTSTANDING JANUARY 1, 1939.

Philadelphia Rapid Transit Company 5% Collateral Bonds, due February 1, 1957	$2,107,000*†
Union Traction Company of Philadelphia 4% 50-Year Sinking Fund Collateral Trust Mortgage Bonds, due July 1, 1952	523,000†
TOTAL	$2,630,000*†

*Estimated amount giving effect to estimated sinking fund retirements to January 1, 1939.

¶ Ground rents which do not have a stated principal amount for redemption thereof are stated at an amount which represents a capitalization of the annual payments on a 6% basis.

† In exchange for the collateral security now held by the Trustees of the aforesaid Collateral Trust Bonds, there will be issued 3%-6% Consolidated Mortgage Bonds of Transportation Company due January 1, 2039, described in Section 3 (b) above, as follows: (1) to the Trustee of $2,107,000 face amount of Philadelphia Rapid Transit Company 5% Collateral Bonds due February 1, 1957 outstanding, in exchange for said existing collateral security therefor, $9,476,700 face amount of said 3%-6% Consolidated Mortgage Bonds; and (2) to the Trustee of $523,000 face amount of Union Traction Company of Philadelphia 4% Sinking Fund Collateral Trust Mortgage Bonds due July 1, 1952, outstanding, in exchange for said existing collateral security therefor, $2,333,400 face amount of said 3%-6% Consolidated Mortgage Bonds. These said additional Consolidated Mortgage Bonds, which will be in the total face amount of $11,810,100, will be owned by Transportation Company and not outstanding in the hands of the public but held by the Trustees for the aforesaid collateral trust bonds as collateral security therefor; the said two respective amounts of said Consolidated Mortgage Bonds are in such amount that the fixed interest thereon would equal the interest and sinking fund payments required by the indentures under which the aforesaid respective collateral trust bonds were issued. Such Consolidated Mortgage Bonds shall be cancelled upon the retirement of the said respective obligations which they will secure.

SCHEDULE "E-3"

DIVISIONAL LIEN BONDS OUTSTANDING JANUARY 1, 1939.

Continental Passenger Railway Company of Philadelphia First Mortgage 4% Bonds, due July 1, 1959	$280,000
Frankford & Southwark Philadelphia City Passenger Railroad Company, (Lombard & South Street Passenger Railway Company) First Mortgage 3½% Bonds, due December 1, 1951	150,000
Market Street Elevated Passenger Railway Company First Mortgage 4% Bonds, due May 1, 1955	10,000,000
Peoples Passenger Railway Company Second Mortgage 4% Bonds, due July 15, 1961	285,000
Peoples Passenger Railway Company Consolidated Mortgage 4% Bonds, due March 1, 1962	246,000
Philadelphia City Passenger Railway Company First Mortgage 4% Bonds, due January 1, 1960	200,000
Philadelphia & Darby Railway Company, The, First Mortgage 5¾% Bonds, due May 1, 1957	100,000
Philadelphia Rapid Transit Company 50-Year 5% and 6% Sinking Fund Bonds, due March 1, 1962 (Second Mortgage on Market Street Subway-Elevated)	7,859,000†
Philadelphia and Willow Grove Street Railway Company 4½% Mortgage Bonds, due July 1, 1939	363,300†

†$283,000 face amount additional of P.R.T. Co. 50 Year 6% Sinking Fund Bonds due Mar. 1, 1962 and $100,100 face amount additional Phila. & Willow Grove St. Ry. Co. 4½% Mtge. Bonds due July 1, 1939 will be owned by Transportation Company and not outstanding in the hands of the public but held by the Trustee of the sinking fund for said Phila. & Willow Grove St. Ry. Co. bonds; they will be cancelled when said obligations they secure are retired.

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Thirteenth and Fifteenth Streets Passenger Railway Company of the City of Philaphia 6% First Mortgage Bonds, due January 1, 1944	$436,000
Union Passenger Railway Company of Philadelphia First Mortgage 4% Bonds, due March 31, 1961	500,000
Union Passenger Railway Company of Philadelphia Second Mortgage 4% Bonds, due March 31, 1960	250,000
West Philadelphia Passenger Railway Company First Mortgage 3½% Bonds, due April 1, 1956	246,000
West Philadelphia Passenger Railway Company Second Mortgage 5½% Bonds, due May 1, 1956	750,000
TOTAL	$21,665,300†

SCHEDULE "E-4"

PHILADELPHIA TRANSPORTATION COMPANY FIRST AND REFUNDING MORTGAGE 4% BONDS OUTSTANDING JANUARY 1, 1939.

Issued to Holders of

Darby and Yeadon Street Railway Company 4½% First Mortgage Bonds, due December 1, 1934	$200,000
Peoples Passenger Railway Company First Mortgage 4% Bonds, due January 15, 1935	219,000
Philadelphia City Passenger Railway Company 5% Debenture Coupon Bonds, due March 1, 1935	100,000

†$283,000 face amount additional of P.R.T. Co. 50 Year 6% Sinking Fund Bonds due Mar. 1, 1962 and $100,100 face amount additional Phila. & Willow Grove St. Ry. Co. 4½% Mtge. Bonds due July 1, 1939 will be owned by Transportation Company and not outstanding in the hands of the public but held by the Trustee of the sinking fund for said Phila. & Willow Grove St. Ry. Co. bonds; they will be cancelled when said obligations they secure are retired.

Empire Passenger Railway Company of Philadelphia 6% First Mortgage Bonds, due March 1, 1935	$100,000*
Catherine & Bainbridge Streets Railway Company of the City of Philadelphia, The, First Mortgage 6% Bonds, due April 1, 1935	150,000
Frankford & Southwark Philadelphia City Passenger Railroad Company, (West End Passenger Railway Company) First Mortgage 4% Bonds, due October 1, 1935	132,100
Hestonville, Mantua & Fairmount Passenger Railroad Company 5½% Consolidated Bonds, due May 1, 1934 and May 1, 1939	896,760
Seventeenth & Nineteenth Streets Passenger Railway Company of Philadelphia First Mortgage 6% Bonds, due July 1, 1939	100,000
Total to be presently issued for refunding	$1,897,860*

SCHEDULE "E-5"

PHILADELPHIA TRANSPORTATION COMPANY 3%-6% CONSOLIDATED MORTGAGE BONDS OUTSTANDING JANUARY 1, 1939.

Issued to holders of the following stocks and stock trust certificates:

Citizens Passenger Railway Company of Philadelphia	$1,008,500.00
Continental Passenger Railway Company of Philadelphia	749,200.00

*$100,000 face amount additional First and Refunding 4% Mortgage Bonds will be issued in exchange for $100,000 face amount additional Empire Pass. Ry. Co. of Phila. 6% 1st Mtge. Bonds, due Mar. 1, 1935; they will be owned by Transportation Company and not outstanding in the hands of the public but held by the Trustee of the sinking fund for the Phila. & Willow Grove St. Ry. Co. 4½% Mtge. Bonds due July 1, 1939; they will be cancelled when said obligations they secure are retired.

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Fairmount Park & Haddington Passenger Railway Company, The	$129,660.00
Frankford & Southwark Philadelphia City Passenger Railroad Company	4,862,625.00
Germantown Passenger Railway Company	1,134,600.00
Green & Coates Streets Philadelphia Passenger Railway Company	432,300.00
Philadelphia City Passenger Railway Company	1,076,223.57
Philadelphia & Darby Railway Company, The	39,408.20
Philadelphia & Grays Ferry Passenger Railway Company	354,370.72
Ridge Avenue Passenger Railway Company	1,296,750.00
Second & Third Streets Passenger Railway Company of Philadelphia	1,833,085.80
Thirteenth & Fifteenth Streets Passenger Railway Company of the City of Philadelphia	1,724,677.50
Union Passenger Railway Company of Philadelphia	1,416,879.10
West Philadelphia Passenger Railway Company	445,027.12
Peoples Passenger Railway Company Stock Trust Certificates	1,195,864.00
Hestonville, Mantua & Fairmount Passenger Railroad Company:	
Common	33,915.76
Preferred	74,609.70
Philadelphia Traction Company	6,728,000.00
Electric & Peoples Traction Stock Trust Certificates	4,980,365.73
Union Traction Company of Philadelphia	2,407,895.58
Darby, Media & Chester Street Railway Company	49,640.00
TOTAL	$31,973,597.78

Issued to holders of the following bonds:

Darby, Media and Chester Street Railway Company 4½% First Mortgage Bonds, due July 1, 1936	$396,400.00
Doylestown and Willow Grove Railway Company First Mortgage 4% Bonds, due June 1, 1960	200,000.00
TOTAL	$596,400.00
TOTAL	$32,569,997.78*

*In addition to the Consolidated Mortgage Bonds to be issued in exchange for stock and/or stock trust certificates of Lessor Companies, and in addition to the Consolidated Mortgage Bonds to be issued in refunding certain outstanding bonds of Lessor Companies, as set forth above, there will also be issued: (1) to the Trustee of $523,000 face amount of Union Traction Company of Philadelphia 4% Sinking Fund Collateral Trust Mortgage Bonds due July 1, 1952, outstanding, in exchange for the existing collateral security therefor, $2,333,400 face amount of the aforesaid 3%-6% Consolidated Mortgage Bonds of Transportation Company; and (2) to the Trustee of $2,107,000 face amount of Philadelphia Rapid Transit Company 5% Collateral Bonds due February 1, 1957 outstanding, in exchange for the existing collateral security therefor, $9,476,700 face amount of said 3%-6% Consolidated Mortgage Bonds. These said additional Consolidated Mortgage Bonds, which will be in the total face amount of $11,810,100, will be owned by Transportation Company and not outstanding in the hands of the public but held by the Trustees for the aforesaid collateral trust bonds as collateral security therefor; the said two respective amounts of said Consolidated Mortgage Bonds are in such amount that the fixed interest thereon would equal the interest and sinking fund payments required by the indentures under which the aforesaid respective collateral trust bonds were issued. Such Consolidated Mortgage Bonds shall be cancelled upon the retirement of the said respective obligations which they will secure.

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EXHIBIT 6-F: FORM OF CONSOLIDATED MORTGAGE BOND AND COUPONS.

(Form of Bond)

$100 $100

PHILADELPHIA TRANSPORTATION COMPANY

Consolidated Mortgage 3%-6%, Bond Series A
Due January 1, 2039

No. C00000 No. C00000

PHILADELPHIA TRANSPORTATION COMPANY hereinafter called the Company, a corporation of the Commonwealth of Pennsylvania, for value received, hereby promises to pay to bearer, or if this bond be registered as to principal to the registered holder hereof, on the first day of January, 2039, at the office of Fidelity-Philadelphia Trust Company in the City of Philadelphia, Commonwealth of Pennsylvania, or at the office in said city of any successor paying agent, or at the office of the paying agent of the Company in the Borough of Manhattan, The City and State of New York, the principal sum of One Hundred Dollars in such coin or currency of the United States of America as at the time of payment is legal tender for the payment of public and private debts, and to pay fixed interest on said principal sum at either of said offices in like coin or currency from January 1, 1939, until this bond shall be paid or the payment or redemption hereof duly provided for, at the rate of Three Per Cent. (3%) per annum, payable semi-annually on the said first days of January and July in each year, but only upon the presentation and surrender of the fixed interest coupons hereto annexed as they severally mature.

The Company further promises to pay for each year income interest to the extent to which net income is suf-

ficient up to Three Per Cent. (3%) per annum, in addition to the said fixed interest of Three Per Cent. (3%) per annum, the extent to which net income is sufficient for the payment of said income interest being determined from an annual income statement covering the twelve months ending December 31 of each year all as more particularly set forth in the indenture hereinafter referred to. Notice of the amount of such income interest for each preceding year will be given by the Company to the Trustee on or before May 1 of each year and the said income interest is payable, at either of said offices, in such coin or currency of the United States of America as at the time of payment is legal tender for the payment of public and private debts, annually on the first day of July in each year, but only upon the presentation and surrender of the income interest coupons hereto annexed as they severally mature. Said income interest is non-cumulative and shall be paid only for the years in which net income is sufficient therefor.

Principal of this bond and interest hereon are payable without deduction for any personal property taxes or corporate loans taxes that may be imposed by the Commonwealth of Pennsylvania up to but not exceeding five mills per annum in the aggregate on each dollar of the principal amount hereof which the Company or any officer thereof or the Trustee hereinafter referred to may be required to pay thereon, or to deduct or retain therefrom under any present or future law of the Commonwealth of Pennsylvania.

The Company reserves the right to require the holder of this bond or of any coupon detached herefrom, in connection with the payment of this bond or of such coupon, to present to Fidelity-Philadelphia Trust Company or any successor or other paying agent a certificate, in such form as the Company may from time to time prescribe, to enable it to determine its duties and liabilities with respect

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to any taxes, assessments or governmental charges which it may be required to deduct or withhold therefrom under any present or future law of the United States of America or of any state, county, municipality or taxing authority therein and giving, among other information, the identity and residence of the owner or holder of this bond or of such coupon; and the Company shall be entitled to determine its duties and liabilities with respect to such deduction or withholding on the basis of the information contained in such certificate or, if no such certificate shall be so presented on the basis of any presumption created by any such law, and shall be entitled to act in accordance with such determination.

This bond is one of a series of bonds, in both coupon form with interest coupons attached and fully registered form without interest coupons, designated as Consolidated Mortgage 3%-6% Bonds Series A due January 1, 2039. The bonds of the said series are part of an issue of bonds of the Company authorized under and pursuant to and all secured by an indenture of mortgage, or deed of trust, dated as of January 1, 1939, (hereinafter referred to as the indenture), duly executed and delivered by the Company to Fidelity-Philadelphia Trust Company as Trustee, to which indenture, including all indentures supplemental thereto, reference is hereby made for a description of the property mortgaged, the nature and extent of the security and the rights and limitations of rights thereunder of the holders of the said bonds and coupons and of the Company and the rights, duties and immunities thereunder of the Trustee. No bondholder or bondholders shall be entitled to institute any action, suit or any proceedings whatsoever for the enforcement of said indenture, or any right thereunder, except as therein provided. The said bonds are issuable in successive series, which may vary as to date, date of maturity, rate of interest and in other ways in the said indenture provided.

44a *Form of Consolidated Mortgage Bond and Coupons.*

This bond is subject to redemption at any time upon notice published once a week for at least four (4) consecutive weeks in a daily newspaper printed in the English language and published and of general circulation in the Borough of Manhattan, The City and State of New York and in a similar newspaper published and of general circulation in the City of Philadelphia, Commonwealth of Pennsylvania, the first publication to be at least thirty (30) days prior to the date fixed for redemption, as provided in the indenture, by payment of the principal amount hereof with accrued fixed interest to the date fixed for redemption and by payment of a further sum equal to interest at the maximum income interest rate of Three Per Cent. (3%) per annum to the date fixed for redemption from the end of the last calendar year for which income interest has been paid or would, at the date fixed for redemption, have been paid, if earned.

This bond is entitled to the benefits and security of a Sinking Fund as provided in said indenture.

In case of default as defined in said indenture, the principal of all bonds secured by said indenture may be declared due and payable in the manner and with the effect provided in said indenture.

This bond shall pass by delivery unless registered as to the principal hereof in the holder's name at the office of the Trustee in the City of Philadelphia, Commonwealth of Pennsylvania, or at the office in said city of any successor agent of the Company for such purpose or at the office of an agent of the Company appointed for such purpose in the Borough of Manhattan, The City and State of New York, such registry being noted on the bond by the agent of the Company for such purpose, after which no transfers shall be valid unless made in either of such offices by the registered holder in person or by his attorney duly authorized in writing and similarly noted on the bond; but thereafter this bond may be discharged

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from registration by being transferred in like manner to bearer and thereupon transferability by delivery shall be restored, and it may again from time to time be registered or transferred to bearer as before. No such registration, however, shall affect the negotiability of the interest coupons hereto annexed, which shall continue to be payable to bearer and transferable by delivery merely and the payment thereof to bearer shall fully discharge the Company in respect of the interest therein mentioned, whether or not this bond be registered.

The coupon bonds of this Series A are issuable in the denominations of One Hundred Dollars ($100.), Five Hundred Dollars ($500.) and One Thousand Dollars ($1,000.). Coupon bonds of this Series A totalling Five Hundred Dollars ($500.) in principal amount may be exchanged for a coupon bond of this Series A in the principal amount of Five Hundred Dollars ($500.), and coupon bonds of this Series A totalling One Thousand Dollars ($1,000.), in principal amount may be exchanged for a coupon bond of this Series A in the principal amount of One Thousand Dollars ($1,000.) upon surrender for cancellation of the bonds to be so exchanged with all unmatured coupons attached. The registered bonds without coupons of this Series A are issuable in multiples of One Thousand Dollars ($1,000.) in such denominations as the Company may determine, but in no event in denominations of less than Ten Thousand Dollars ($10,000.). Except in the case of a bond drawn for redemption, the coupon bonds and the registered bonds without coupons are interchangeable in authorized denominations and like principal amounts; and in and by the indenture it is covenanted that upon payment of the charges and otherwise as provided therein, any such interchange may be made by the holder of any bond or bonds upon presentation thereof for that purpose at the office of the Trustee, in the City of Philadelphia, Commonwealth of Pennsylvania, or at the office in said

city of any successor agent of the Company for such purpose, or at the office of an agent of the Company appointed for such purpose in the Borough of Manhattan, The City and State of New York.

This bond is issued, delivered, and intended to circulate as a negotiable instrument, unless registered. Each successive holder or owner hereof, or of any interest coupon appertaining hereto by accepting the same, shall be deemed to have agreed that this bond, unless registered, and the coupons hereto appertaining, whether or not this bond be registered, shall be construed as negotiable instruments; that every holder's or owner's rights, risks and remedies in respect to this bond, unless registered, and in respect to the interest coupons hereto appertaining, whether or not this bond be registered, shall be those of holders or owners of negotiable instruments; that the Company and the Trustee may deem and treat the bearer of this bond, if not registered, and if registered, the registered holder hereof, and the bearer of the interest coupons appertaining to this bond, whether or not this bond be registered, as the absolute owner hereof or thereof for all purposes, and shall not be affected by any notice to the contrary; and that the purchaser, for value and without notice of prior equities, of this bond, unless registered, or of any coupon hereto appertaining, whether or not this bond is registered shall be and become the absolute owner of this bond or of such coupon, unaffected by any rights or equities of any previous holder or owner hereof or thereof.

No recourse shall be had for the payment of the principal of this bond, or interest hereon, or for any claim based hereon, or in respect hereof, or of said indenture against any stockholder, officer or director of any constituent corporation merged and consolidated into the Company, or any past, present or future stockholder, officer or director of the Company or of any successor

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corporation as such, either directly or through the Company or through a receiver or trustee, whether by virtue of any constitution, statute or rule of law, or by the enforcement of any assessment or penalty or otherwise, all such liability being by the acceptance hereof and as part of the consideration for the issue hereof, expressly released.

This bond shall not become valid or obligatory for any purpose until it shall have been authenticated by the execution of the certificate hereon endorsed by the Trustee under the said indenture.

In Witness Whereof Philadelphia Transportation Company has caused this bond to be signed in its corporate name by its President, or one of its Vice-Presidents, and its corporate seal, or a facsimile thereof, to be hereunto affixed and attested by its Secretary or one of its Assistant Secretaries, and coupons for fixed interest and for income interest bearing the facsimile signature of its Treasurer to be attached hereto as of the first day of January, A. D. 1939.

PHILADELPHIA TRANSPORTATION COMPANY,
By

President.

[SEAL]
Attest:

Secretary.

Any United States documentary stamps required by law in connection with the issuance of this bond have been or will be affixed to the within-mentioned Indenture and duly cancelled.

48a *Form of Consolidated Mortgage Bond and Coupons.*

(Form of Fixed Interest Coupon)

On the first day of July 1939 (unless the bond below mentioned shall have been called for previous redemption and payment duly provided for), PHILADELPHIA TRANSPORTATION COMPANY, for value received, will pay to the bearer, on surrender of this coupon, at the office of Fidelity-Philadelphia Trust Company in the City of Philadelphia, Commonwealth of Pennsylvania, or at the office in said city of any successor paying agent, or at the office of the paying agent of the Company in the Borough of Manhattan, the City and State of New York, One and 50/100 Dollars ($1.50) in such coin or currency of the United States of America as at the time of payment is legal tender for the payment of public and private debts, without deduction for Pennsylvania personal property or corporate loans taxes up to but not exceeding five mills per annum in the aggregate on each dollar of the principal amount of the bond to which this coupon is attached, being six months' fixed interest then due on its consolidated mortgage 3%-6% Bond Series A due January 1, 2039.

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GEORGE W. DAVIS,
Treasurer.

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Form of Consolidated Mortgage Bond and Coupons. 49a

(Form of Income Interest Coupon)

On the first day of July 1940 (unless the bond below mentioned shall have been called for previous redemption and payment duly provided for), PHILADELPHIA TRANSPORTATION COMPANY, for value received, will pay to the bearer, on surrender of this coupon, at the office of Fidelity-Philadelphia Trust Company, in the City of Philadelphia, Commonwealth of Pennsylvania, or at the office in said city of any successor paying agent, or at the office of a paying agent of the Company in the Borough of Manhattan, the City and State of New York, the amount of income interest, if any, payable for the year ending, December 31 next preceding said July 31 in accordance with the Bond to which this coupon is attached, in such coin or currency of the United States of America as at the time of payment is legal tender for the payment of public and private debts, without deduction for Pennsylvania personal property or corporate loans taxes up to but not exceeding five mills per annum in the aggregate on each dollar of the principal amount of said Bond, being consolidated mortgage 3%-6% Bond Series A due January 1, 2039.

No. C 00000

GEORGE W. DAVIS,
Treasurer.

PETITIONER'S EXHIBIT 15: LETTER RULING OF OCTOBER 9, 1940 FROM DEPUTY COMMISSIONER.

TREASURY DEPARTMENT

Washington

[Seal]

Office of
Commissioner of Internal Revenue

Address Reply to
Commissioner of Internal Revenue
and Refer to

IT:P:T:2 Oct 9-1940
RLB

Pennsylvania Transportation Company,
Mitten Building,
Philadelphia, Pennsylvania.

Attention: H. Renner, Jr.,
Assistant Comptroller.

Sirs:

Further reference is made to your letter of September 23, 1940, and accompanying copy of the Second Revised Plan of Reorganization of your company left in the Bureau by H. Renner, Jr., Assistant Comptroller, on September 24, 1940.

Mr. Renner has requested a specific ruling with regard to the treatment, for the purposes of the Federal income tax, of the amounts paid by your company as interest on its Consolidated Mortgage Bonds, the filing of ownership certificates on form 1012 with respect to such interest payments, and the withholding of tax at the source with regard to the interest payments made to nonresident alien bondholders.

It is the contention of Mr. Renner that since your company did not exist as a separate taxable entity prior to January 1, 1940, although the Plan of Reorganization

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of December 1, 1937, as amended June 1, 1938 and November 15, 1938, under which it commenced operations provided for the payment of interest on the Consolidated Bonds as of January 1, 1939, the amounts paid in January 1940 should not be regarded as "true interest" on indebtedness.

The authorized capitalization of your company consists, in part, of the Consolidated Mortgage Bonds secured by a mortgage and deed of trust, junior to the deed of trust and mortgage securing the first and refunding mortgage bonds. The Consolidated Bonds were issued in exchange for stock and/or stock trust certificates of lessor companies outstanding in the hands of the public. All of these bonds are of a single series dated January 1, 1939, and mature on January 1, 2039, bear a fixed interest at the rate of 3 percent per annum and, under certain conditions mentioned in the Plan of Reorganization additional interest may be paid at the rate of 3 percent per annum. (Section 3(b) of the Plan of Reorganization as revised.)

The gross amount representing the interest payment made in January 1940 was not taken into consideration in the Plan of Reorganization, as revised, which was determined by this office to be a nontaxable transaction.

Gross income as defined in section 22(a) of the Internal Revenue Code includes interest. The fact that a corporate entity was not actually in existence as of the accrual date of interest on an outstanding obligation does not change the character of the income. The distribution under consideration in the instant case is held to represent a payment of interest on an outstanding obligation. Accordingly, as the payments made in January 1940 represent payments of interest, ownership certificates are required with respect to such payments. Furthermore, tax at the prescribed rate must be deducted and withheld from all payments of interest made to nonresident alien bondholders. (Section 143(b) of the

52a *Letter Ruling of October 9, 1940 from Deputy Commissioner.*

Internal Revenue Code and section 143(b) of the Internal Revenue Code, as amended.)

Respectfully,

TIMOTHY C. MOONEY,
Deputy Commissioner,

By
L. K. SUNDERLIN
Chief of Section.

TREASURY DEPARTMENT

Washington

[Seal]

Office of
Commissioner of Internal Revenue

Address Reply to
Commissioner of Internal Revenue
and Refer to

IT:P:T:2
RLB

Oct 14 1940

Philadelphia Transportation Company,
Mitten Building,
Philadelphia, Pennsylvania.

Attention: H. Renner, Jr.,
Assistant Comptroller.

Sirs:

Your attention is invited to the fact that in Bureau letter of October 9, 1940, your company was addressed in the name of Pennsylvania Transportation Company instead of Philadelphia Transportation Company. A conformed carbon copy with your name and address properly shown is attached.

Respectfully,

TIMOTHY C. MOONEY,
Deputy Commissioner.

By
L. K. SUNDERLIN
Chief of Section.

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Letter Ruling of October 9, 1940 from Deputy Commissioner. 53a

IT:P:T:2
RLB

October 9, 1940.

Philadelphia Transportation Company,
Mitten Building,
Philadelphia, Pennsylvania.

Attenion: H. Renner, Jr.,
Assistant Comptroller.

Sirs:

Further reference is made to your letter of September 23, 1940, and accompanying copy of the Second Revised Plan of Reorganization of your company left in the Bureau by H. Renner, Jr., Assistant Comptroller, on September 24, 1940.

Mr. Renner has requested a specific ruling with regard to the treatment, for the purposes of the Federal income tax, of the amounts paid by your company as interest on its Consolidated Mortgage Bonds, the filing of ownership certificates on form 1012 with respect to such interest payments, and the withholding of tax at the source with regard to the interest payments made to nonresident alien bondholders.

It is the contention of Mr. Renner that since your company did not exist as a separate taxable entity prior to January 1, 1940, although the Plan of Reorganization of December 1, 1937, as amended June 1, 1938 and November 15, 1938, under which it commenced operations provided for the payment of interest on the Consolidated Bonds as of January 1, 1939, the amounts paid in January 1940 should not be regarded as "true interest" on indebtedness.

The authorized capitalization of your company consists, in part, of the Consolidated Mortgage Bonds secured by a mortgage and deed of trust, junior to the deed of trust and mortgage securing the first and refunding mort-

gage bonds. The Consolidated Bonds were issued in exchange for stock and/or stock trust certificates of lessor companies outstanding in the hands of the public. All of these bonds are of a single series dated January 1, 1939, and mature on January 1, 2039, bear a fixed interest at the rate of 3 percent per annum and under certain conditions mentioned in the Plan of Reorganization additional interest may be paid at the rate of 3 percent per annum. (Section 3(b) of the Plan of Reorganization as revised.)

The gross amount representing the interest payment made in January 1940 was not taken into consideration in the Plan of Reorganization, as revised, which was determined by this office to be a nontaxable transaction.

Gross income as defined in section 22(a) of the Internal Revenue Code includes interest. The fact that a corporate entity was not actually in existence as of the accrual date of interest on an outstanding obligation does not change the character of the income. The distribution under consideration in the instant case is held to represent a payment of interest on an outstanding obligation. Accordingly, as the payments made in January 1940 represent payments of interest, ownership certificates are required with respect to such payments. Furthermore, tax at the prescribed rate must be deducted and withheld from all payments of interest made to non resident alien bondholders. (Section 143(b) of the Internal Revenue Code and section 143(b) of the Internal Revenue Code, as amended.)

Respectfully,

TIMOTHY C. MOONEY,
Deputy Commissioner.

By
(Signed) L. K. SUNDERLIN
Chief of Section.

RLB/AJ-2(KSP)

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PETITIONER'S EXHIBIT 16: LETTER OF JANUARY 19, 1943 FROM INTERNAL REVENUE AGENT IN CHARGE ACCEPTING 1940 INCOME TAX RETURN.

TREASURY DEPARTMENT

Internal Revenue Service

[Seal]
Office of
Internal Revenue Agent in Charge
..... Division

January 19, 1943.

Philadelphia Transportation Co.
Mitten Building
Broad & Locust Streets
Philadelphia, Pa.

In re: Income Tax Return
Year(s) covered: 1940

Upon examination of your income tax return(s) for the year(s) indicated above, the conclusion has been reached that it (they) should be accepted as filed.

I am sure you will appreciate that should subsequent information be received which would materially change the amount reported, it will be necessary under existing laws to redetermine your tax liability.

Respectfully,

(signed) R. T. MILES
Internal Revenue Agent in Charge.

Form 850-C
Revised May 1942
FFR

U. S. Government Printing Office 16-8569-1

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UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

No. 9772

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILADELPHIA TRANSPORTATION COMPANY, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

Argued February 23, 1949

Before GOODRICH, WALLER, and MCLAUGHLIN, Circuit Judges

OPINION OF THE COURT

(Filed March 21, 1949)

By GOODRICH, Circuit Judge.

The Philadelphia Transportation Co., the taxpayer here, was formed on January 1, 1940 as the culmination of reorganization proceedings involving 65 corporations concerned in Philadelphia's public transportation system. In accordance with the reorganization plan, the taxpayer issued, in January, 1940, mortgage bonds dated January 1, 1939 and bearing interest from that date. The interest coupons for 1939 and 1940 were redeemed by the taxpayer in 1940, as required by the reorganization plan.

The taxpayer computes its tax liability on an accrual basis. In its income tax return for 1940, it claimed a deduction for the 1939 and 1940 coupons as "interest accrued" in 1940.[1]

These basic facts raise the crucial question, the answer to which will dispose of the case. Was the interest allocated as 1939 interest properly deducted from the taxpayer's 1940 income as interest accrued in 1940? The Tax Court held that it was. In this appeal, the Commissioner seeks reversal on three principal grounds. He argues, first, that the amount deducted was not interest. It was not interest, he says, because interest is compensation for the use of money, and the taxpayer held no money,

[1] The applicable section of the Internal Revenue Code, § 23 (b), provides:
"Sec. 23. Deductions from Gross Income. In computing net income there shall be allowed as deductions:
* * * * *
(b) Interest.—All interest paid or accrued within the taxable year on indebtedness * * *." 26 U. S. C. A. § 23 (b).

borrowed or otherwise, in 1939. The Commissioner looks for support on this point to the statutory language which refers to "interest accrued on indebtedness." He concludes that without indebtedness in 1939, there could have been no interest. And there was no indebtedness in 1939, he says, because the taxpayer had no corporate existence then.

The Commissioner's second point is that the taxpayer really took over the obligation to pay 1939 interest as a part of the cost of the assets acquired in the reorganization. We discuss this point below. And finally the Commissioner argues that even if the amount in question be treated as interest, a deduction of interest for more than the current year may not be made from that year's income.

The point last stated is easily answered. No provision of the Internal Revenue Code prohibits such a deduction. Section 43 of the Code, 26 U. S. C. A. § 43, provides that "the liabilities of one year cannot be used to reduce the income of a subsequent year." It is upon this provision that the Commissioner relies. But the issue is whether the item in question here is a liability of the year 1940. If it accrued in 1940, it is deductible in 1940 and in no other year, whether or not it is based on transactions allocated for other purposes to other periods. One decision specifically supports the deduction of 2 years' interest in one year in a proper case,[2] and three other decisions, including one from this Court, support the proposition in principle.[3]

We turn, then, to the Commissioner's first two arguments. We think that the fog surrounding the no debt-no interest contention is best cleared by a simply hypothetical illustration. A corporation is formed in 1940. It is brand new and without corporate forbears. It issues in 1940 a series of 20-year coupon bonds. For reasons best known to the management, it is decided to date the bonds as of January 1, 1939 to mature January 1, 1959, and to redeem the first two interest coupons in 1940. The corporation pays its taxes on an accrual basis. Can there be any doubt that the interest accrued on the two coupons in 1940 and was properly deductible in that year? We think that in the hypothetical case the situation is the same as if the 1940 interest coupons were just double the later ones in amount. There was indebtedness in 1940, interest accrued on that indebtedness in 1940, and we think it is chargeable for tax purposes, as well as bookkeeping purposes, for that year.

---

[2] Oregon Pulp & Paper Co. v. Commissioner, 47 BTA 722 (1942), petition for review dismissed (C. C. A. 9, November 2, 1943).

[3] Commissioner v. Pressed Steel Car Co., Inc., 152 F. 2d 280 (C. C. A. 3, 1945); Ernst Kern Co. v. Commissioner, 1 T. C. 249 (1942); Columbia River Paper Mills v. Commissioner, 43 BTA 104 (1940), aff'd 126 F. 2d 2009 (C. C. A. 9, 1942). It is true that our decision was made at a time when the Dobson case blinders prevented the judicial eye from roving over the record. We think the result was right though, perforce, compelled.

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We think the present case is similar to the hypothetical one in all respects except that the taxpayer was the product of a reorganization and came into existence with the obligation to pay fixed and variable interest on the bonds it was to issue to the shareholders of its corporate predecessors. These added factors do not, in our judgment, alter the result. The taxpayer, as a new corporation, created its own new indebtedness. It did not assume existing liabilities on which interest had already accrued against predecessor companies. If it had, there would be merit in the Commisisoner's point that the obligation was part of the cost of the asests acquired by the taxpayer.[4]

But that is not the fact. No obligation was owed by the predecessor companies to their shareholders except insofar as assets might have remained for distribution to them when corporate affairs were wound up. Moreover, neither the present taxpayer nor any of its predecessors was in a position to take advantage of a 1939 deduction for the interest payments in question. As our brethren in the Ninth Circuit said in Commissioner v. Columbiæ River Paper Mills, 126 F. 2d 1009, 1010 (C. C. A. 9, 1942): "The arrangement was a logical one under the circumstances, * * * It is not suggested that there was any purpose of tax avoidance * * *." We conclude, therefore, as we did in Pressed Steel Car Co. v. Commissioner, 152 F. 2d 280 (C. C. A. 3, 1946), that the Tax Court correctly decided that the amount in dispute represented accrued interest within the meaning of Section 23 (b) of the Internal Revenue Code.[5]

The decision of the Tax Court will be affirmed.

WALLER, Circuit Judge, dissenting: It is with regret that I cannot bring myself in line with the excellent opinion of the majority in this case. I cannot escape the force of innumerable opinions of courts throughout the country holding that interest is the premium paid for the use of money, or—as held by the Supreme Court in Deputy Administratrix v. Dupont, 308 U. S. 488 (text 497)—that interest "is the amount which one has contracted to pay for the use of borrowed money."

---

[4] Cases in which the indebtedness was that of the taxpayer's vendor or predecessor, and was taken over by the taxpayer with the obligation to pay interest already accrued, have been properly treated as capital transactions. Commissioner v. Breyer, 151 F. 2d 267, 272 (C. C. A. 3, 1945); Rodney v. Commissioner, 145 F. 2d 692 (C. C. A. 2, 1944); Pratt-Mallory Co. v. United States, 12 F. Supp. 1020, 1023 (Ct. Cl. 1936). Cases like Lloyd v. Commissioner, 154 F. 2d 643 (C. C. A. 3, 1946), in which the proceeds of the sale of unmatured interest coupons by a banking syndicate which was not the obligor were held improperly declared as a deduction for payment of "interest," are clearly without application to the present case.

[5] All the authorities on this point have reached the same result, with one exception. Commissioner v. Pressed Steel Car Co., Inc., 152 F. 2d 280 (C. C. A. 3, 1945); Ernst Kern Co. v. Commissioner, 1 T. C. 249 (1942); Columbia River Paper Mills v. Commissioner, 43 BTA 104 (1940), aff'd 126 F. 2d 1009 (C. C. A. 9, 1942); Oregon Pulp & Paper Co. v. Commissioner, 47 BTA 722 (1942), petition for review dismissed (C. C. A. 9, November 2, 1943). Contra: Commissioner v. Drovers Journal Publishing Co., 135 F. 2d 276 (C. C. A. 7, 1943).

In 1939 the taxpayer here borrowed no money, acquired no property, used no money or property of others, and owed no debts to which interest could have been an incident. On the contrary it was not in existence until January 1, 1940, and neither made, nor could have made, any contract prior to its coming into being. It, doubtless, could have ratified, upon its organization, lawful contracts theretofore made by its promoters, but the procedure adopted was not that of ratifying a prior contract made by its promoters but of making its own contract whereby it sought to engage in the Canutian pastime of turning back the tide for one year and thus to pay interest on money which it never used nor borrowed in 1939, but with which it purchased property in 1940.

The bonds were issued for the acquisition of the assets of the sixty-five affiliated companies. The consideration for the purchase of such assets was the execution and delivery of bonds and interest coupons thus antedated. Before its organization no assets were delivered to it, no money advanced, no forbearance extended. In short, bonds with one year's unearned and unaccrued interest coupons were delivered in consideration for the sale of such assets.

It seems clear that the payment represented by the 1939 coupons was not a payment of "interest" but was merely a part of the consideration for the acquisition of the assets acquired in part therewith, and as such was a capital investment rather than rent for the use of money or its equivalent.

A true Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit.

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United States Court of Appeals for the Third Circuit

No. 9772

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILADELPHIA TRANSPORTATION COMPANY, RESPONDENT

On Petition To Review a Decision of the Tax Court of the United States

Present: GOODRICH, WALLER, and MCLAUGHLIN, Circuit Judges

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

For the Court,

HERBERT F. GOODRICH,
Circuit Judge.

MARCH 21, 1949.

Endorsements—

Judgment Affirming Decision of the Tax Court.

Received and filed Mar. 21, 1949. Ida O. Creskoff, Clerk.

I, Ida O. Creskoff, Clerk of the United States Court of Appeals for the Third Circuit, do hereby certify the foregoing to be a true and faithful copy of the original Appendix to Petitioner's Brief, Appendix to Respondent's Brief, and proceedings in this Court in the case of Commissioner of Internal Revenue, Petitioner vs. Philadelphia Transportation Company, Respondent, No. 9772, on file, and now remaining among the records of the said Court, in my office.

In testimony whereof, I have hereunto subscribed my name and affixed the seal of the said Court, at Philadelphia, this 12th day of May in the year of our Lord one thousand nine hundred and forty-nine, and of the Independence of the United States the one hundred and seventy-third.

[SEAL]

(S) IDA O. CRESKOFF,
Clerk of the U. S. Court of Appeals, Third Circuit.

U. S. GOVERNMENT PRINTING OFFICE: 1949

Supreme Court of the United States

No. 126, October Term, 1949

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

PHILADELPHIA TRANSPORTATION COMPANY

Order allowing certiorari

Filed October 10, 1949

The petition herein for a writ of certiorari to the United States Court of Appeals for the Third Circuit is granted. The case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. —

OMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILADELPHIA TRANSPORTATION COMPANY

TITION FOR A WRIT OF CERTIORARI TO THE NITED STATES COURT OF APPEALS FOR THE HIRD CIRCUIT

The Solicitor General, on behalf of the Commis-ner of Internal Revenue, prays that a writ of rtiorari issue to review the judgment of the urt of Appeals for the Third Circuit entered in above-entitled cause on March 21, 1949.

OPINIONS BELOW

The opinion of the Tax Court (R. 17-37) is re-rted at 9 T. C. 1018. The opinion of the Court Appeals (R. 97-100) is not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals was en-ed on March 21, 1949. (R. 101.) The juris-tion of this Court is invoked under 28 U.S.C., ction 1254.

QUESTION PRESENTED

A corporate taxpayer came into existence on January 1, 1940 as a result of the merger and consolidation of a number of old companies, and on January 29, 1940, issued bonds dated January 1, 1939, purporting to bear interest from the latter date, in exchange for assets of the predecessor companies. In 1940 the taxpayer paid the bondholders a sum of money purporting to be "1939 interest" on its bonds. Is the taxpayer, which computes its taxes on the accrual basis, entitled, under Section 23(b) of the Internal Revenue Code, to deduct from its 1940 income as "interest" the sum so paid?

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and regulations are printed in the Appendix, *infra*, pp. 8-10.

STATEMENT

The facts are not in dispute and, as found by the Tax Court (R. 18-34), may be summarized as follows: The taxpayer came into existence on January 1, 1940, pursuant to a reorganization under the Bankruptcy Act, the plan of which, as approved by the District Court, merged and consolidated 65 preexisting companies into a new company, the taxpayer. (R. 19, 21-22, 25.) On January 29, 1940, as part of the plan, the new company issued to holders of stock and stock trust certificates and to certain holders of bonds of the old companies its 99-year consolidated mortgage bonds. (R. 20.) These bonds were dated Janu-

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ary 1, 1939, and bore "fixed interest" and "income interest" from that date.[1] (R. 20-21.) Simultaneously with the issuance of bonds, the taxpayer delivered to the trustee for the bondholders its check for the "fixed interest" for 1939. (R. 26-27.) On July 1, 1940, the taxpayer paid "income interest" for 1939, at the rate of 2.52%. (R. 30-31.) The two payments of "1939 interest" aggregated about $1,787,000. In 1940, the taxpayer showed a substantial loss, which was carried over. (R. 34.) In determining the taxpayer's net operating loss carry-over for 1942, the Commissioner disallowed the deduction of the "1939 interest" for 1940, giving rise to the deficiency involved in this case.[2] (R. 32.) The taxpayer kept its books and filed its tax returns on the accrual basis. (R. 18.) The applicable section of the statute permits the deduction of "all interest paid or accrued within the taxable year on indebtedness." Internal Revenue Code, Section 23(b).

The Tax Court, upon petition by the taxpayer, held that "the petitioner properly accrued and deducted in its income tax return for 1940, interest

---

[1] "Fixed" interest of 3% was payable in any event; an additional 3% "income" interest was payable "only if and to the extent to which earned" in any year. (R. 20-21, 48; Ex. 7-G, pp. 71-73.)

[2] The taxpayer also deducted the amount which it paid the bondholders in 1940 and 1941 as fixed and income interest for 1940. This deduction was allowed by the Commissioner and is not in issue in this proceeding (R. 31) except to the extent that it is relevant to the question of the propriety of the deduction by a taxpayer on the accrual basis of "interest" for two years in a single year.

in the amount of $1,787,206.88 which it paid in that year." (R. 34, 37.) The Court of Appeals affirmed, one judge dissenting. (R. 97-100.)

REASONS FOR GRANTING THE WRIT

1. As both the Tax Court and the Court of Appeals recognized, the decision is in conflict with that of the Court of Appeals for the Seventh Circuit in *Commissioner* v. *Drovers Journal Pub. Co.*, 135 F. 2d 276. (R. 35, 36, 99, fn. 5.) In that case, a corporation issued, on December 7, 1937, notes bearing interest from January 1, 1937, in exchange for preferred stock of its parent corporation. On December 29, 1937, it paid the noteholders $28,000, representing "interest" from January 1, 1937, and sought to deduct this amount in its income tax return for 1937, under Section 23(b) of the Revenue Act of 1936 (49 Stat. 1648), which corresponds to the present Section 23(b) of the Code. The taxpayer had kept its books and made its returns on the accrual basis. The Commissioner disallowed so much of the "interest" deduction as was attributable to the period between January 1 and December 7. The Tax Court held that the entire $28,000 constituted deductible interest. The Court of Appeals reversed, on the ground that "interest", as used in the statute, means "the amount which one has contracted to pay for the use of borrowed money," and that "since no indebtedness was owing by the respondent * * * prior to December 7, 1937, the $28,000 could not be paid as compensation for pre-December 7 use

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of the $400,000 borrowed on the notes." 135 F. 2d at 278-279. Cf. *Old Colony Railroad Co.* v. *Commissioner,* 284 U.S. 552; *Deputy* v. *Dupont,* 308 U.S. 488, 497. In the present case, the Court of Appeals has sanctioned the deduction of "interest" paid for a period when no indebtedness existed. The conflict is obvious.

2. The dissenting judge in the instant case took the position that the so-called 1939 interest "was not a payment of 'interest' but was merely a part of the consideration for the acquisition of the assets acquired in part therewith, and as such was a capital investment rather than rent for the use of money or its equivalent." (R. 100.) A similar view is implicit in the holding of the Court of Appeals for the Seventh Circuit in *Commissioner* v. *Drovers Journal Pub. Co., supra.* Compare *Pratt-Mallory Co.* v. *United States,* 12 F. Supp. 1020 (Ct. Cl.), which seems also to be in conflict with the instant case. There the taxpayer purchased a business in July, 1925, for a stipulated sum plus "interest" from December, 1924. The court held that the so-called interest was really part of the cost of the property and hence not an allowable deduction from income.

A number of aspects of the present transaction, which are at least anomalous if the payments here concerned are regarded as interest, are readily comprehensible on the hypothesis that the "1939 interest" was simply part of the consideration which the taxpayer paid for its assets. Thus, the

payment of the 1939 "fixed interest" coincided with the issuance of the bonds; the transaction amounted to the delivery of cash and long-term bonds in exchange for assets.[3] Similarly, some of the "1939 interest" plainly amounted to a payment by the taxpayer of the obligations of its predecessor companies—*i.e.*, obligations which it had assumed as part of the purchase price of their assets. Thus, the "income interest" for 1939 could not properly have been paid as an obligation of the taxpayer itself, for it had no income in 1939 and so would have been precluded from paying such interest by the terms of the reorganization plan. (R. 20-21, 48.) Likewise, in cases in which predecessor companies had paid interest on their bonds for the first half of 1939, the taxpayer, when it issued its new bonds in exchange for the old ones, removed Fixed Interest Coupon No. 1—*i.e.*, treated payment by the old companies of part of the 1939 interest due on their bonds as a discharge pro tanto of the taxpayer's obligation to pay "1939 interest" on its bonds. To the extent that the taxpayer has been permitted to deduct as "interest" under Section 23(b) sums which it paid in discharge of the liabilities, accrued before the consolidation and merger, of its predecessor companies, the decision below is in conflict with the holding of the Court of Appeals for the Second

[3] It is significant that, in accordance with regulations of the Pennsylvania Public Utility Commission, the taxpayer's payments in 1940 of "1939 interest" were not charged as an expense in the taxpayer's accounts for 1940. (R. 31.)

Circuit in *Rodney, Inc.* v. *Commissioner,* 145 F. 2d. 692.[4]

3. The question here presented is of great practical importance in the administration of the Internal Revenue Code. As is shown by the cases cited and discussed by the court below, it has frequently been raised in the past; it is involved in four pending cases besides the present one; and it may be expected to arise frequently in the future, unless resolved by this Court.

CONCLUSION

The decision below is wrong and is in conflict with decisions in other circuits. The question is a recurring one and of general importance. For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

JUNE 1949.

---

[4] In the *Rodney* case, the taxpayer corporation acquired all the assets of a subsidiary, which it dissolved, and assumed all its obligations. Thereafter, the taxpayer paid interest which had accrued on the bonds of the dissolved company and attempted to deduct the sum so paid as interest on its own tax return. The Court of Appeals held that the taxpayer's assumption of the subsidiary's liabilities in exchange for its assets was a "capital transaction" and that interest paid by the taxpayer, which had accrued before the purchase, was not "interest" within the meaning of Section 23(b).

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness * * *.

* * * * *

(s) [as added by Section 211 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862.] *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U.S.C. 1946 ed., Sec. 43.)

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SEC. 122 [as added by Section 211 (b) of the Revenue Act of 1939, *supra*]. NET OPERATING LOSS DEDUCTIONS.

(a) [as amended by Section 105 (e)(3)(A) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) [as amended by Section 153 (a) of the Revenue Act of 1942, *supra*] *Amount of Carry-Back and Carry-Over.*—

* * * * *

(2) *Net operating loss carry-over.*—If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the intervening taxable year * * *.

* * * * *

(26 U.S.C. 1946 ed., Sec. 122.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.43-2. *When charges deductible.*—Each year's return, so far as practicable,

both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. * * *.

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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 126

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILADELPHIA TRANSPORTATION COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Tax Court (R. 17-37) is reported at 9 T. C. 1018. The opinion of the Court of Appeals (R. 97-99) together with the dissenting opinion of Judge Waller (R. 99-100) is reported at 174 F. 2d 255.

JURISDICTION

The judgment of the Court of Appeals was entered on March 21, 1949. (R. 101.) A petition for a writ of certiorari was filed on June 16, 1949, and was granted on October 10, 1949. The jurisdiction of this Court is conferred by 28 U. S. C., Section 1254.

QUESTIONS PRESENTED

1. The taxpayer was incorporated on January 1, 1940, to effectuate a plan of reorganization under the Bankruptcy Act. Pursuant to the plan, the taxpayer acquired the assets of the debtor companies and issued its own securities in exchange. These included certain bonds issued on January 29, 1940, but dated January 1, 1939, with interest coupons attached. The taxpayer in 1940 redeemed interest coupons representing "1939 interest."

The question is whether the sums so paid represented "interest" which could, under Section 23 (b) of the Internal Revenue Code, be deducted in 1940.

2. The Commissioner made a timely deficiency determination for the taxable year 1942, in which he reduced the net loss which the taxpayer, under Sections 23 (s) and 122 (b)(2), Internal Revenue Code, carried over from 1940, and in which he disallowed the 1940 interest deduction referred to in question 1. At that time assessment and collection of any tax for 1940 was barred by limitations.

The question is whether, in making a timely deficiency determination for the taxable year 1942, the Commissioner is powerless to correct an erroneous carry-over from 1940, the loss year.[1]

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[1] This question is not raised by the petition for certiorari, nor was it passed upon by the courts below. However, respondent has raised this issue in support of its position, and may renew the point in its brief on the merits. If this Court should decide the first question in the Government's favor, it might then proceed to consider this second question, or it could remand the case to the court below for a consideration of this question.

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STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations are set forth in the Appendix, *infra*, pp. 33-35.

STATEMENT

The facts in this case are not disputed and are evidenced by a stipulation (R. 2-14), by a supplemental stipulation (R. 14-16), by certain exhibits to the stipulation (R. 39-95), and by other exhibits.[2] They may be summarized as follows:

The taxpayer was incorporated on January 1, 1940, to effectuate a plan of reorganization under the Bankruptcy Act. The plan was approved by the bankrupty court on November 14, 1939, and was given an effective date of January 1, 1939. Under the plan, the taxpayer acquired the assets of 65 companies which were merged and consolidated into the new company, the taxpayer. (R. 4-5, 7.)

On January 29, 1940, as part of the plan, the new company issued its consolidated mortgage bonds to holders of stock and stock trust certificates and to holders of bonds in certain of the old companies. These bonds were dated as of the effective date of the plan, January 1, 1939, and coupons were attached for "fixed interest" and "income interest," beginning with that date. (R. 5-6, 7-8, 46-48, 81-89.) Simultaneously with the issuance of the bonds, the taxpayer delivered to the trustee for the bond-

[2] Some of the exhibits have not been reproduced in the printed transcript of record, but are available in the record on review. Where necessary, these will be referred to by their exhibit numbers.

holders its check to redeem the "fixed interest" coupons for 1939. (R. 9-10.) On July 1, 1940, the taxpayer redeemed the "income interest" coupons for 1939, at the rate of 2.52 percent. (R. 10.)

In its tax return for 1940 the taxpayer, which filed its returns on the accrual basis, claimed as a deduction the payments which it made to redeem the 1939 fixed and contingent "interest" coupons.[3] The 1940 return showed a substantial net loss. This net loss was claimed as a deduction in the taxpayer's 1942 return as a carry-over from 1940 under the provisions of Sections 23 (s) and 122 of the Internal Revenue Code. (R. 12-13.) In determining the taxpayer's net operating loss carry-over for 1942, the Commissioner disallowed the deduction in 1940 of the "1939 interest," both fixed and contingent, giving rise to the deficiency involved in this case. (R. 13.)

The Tax Court, upon petition by the taxpayer, held that "the petitioner properly accrued and deducted in its income tax return for 1940, interest in the amount of $1,787,206.88 which it paid in that year." (R. 37.) The Court of Appeals affirmed, one judge dissenting. (R. 97-100.)

Facts relating to the reorganization plan which are particularly relevant to the nature of the pay-

[3] The taxpayer also deducted the amount which accrued during that year on the 1940 fixed and income interest coupons. This deduction was allowed by the Commissioner and is not in issue in this proceeding (R. 11-12), except to the extent that it is relevant to the question of the propriety of the deduction by a taxpayer on the accrual basis of "interest" for two years in a single year.

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ments sought to be deducted as interest are set forth in some detail under the first head of the Argument.

SPECIFICATION OF ERRORS TO BE URGED

The court below erred in holding that the taxpayer accrued an obligation for interest deductible under Section 23 (b) of the Internal Revenue Code where its liability was to redeem "interest" coupons which were predated, and which covered a period prior to the existence of any indebtedness of the taxpayer.

SUMMARY OF ARGUMENT

I

As used in the statute, "interest" means compensation for the use of borrowed funds. "Interest" cannot accrue with respect to a period during which there is no indebtedness. Where, as here, the taxpayer issued securities to effectuate a plan of reorganization, and where those securities were predated to conform to the effective date of the plan, the obligation to pay "interest" for the period which antedated the actual issuance of the securities was an added cost of acquiring the reorganization assets. It was not compensation for the use of borrowed funds, since there was no borrowing by the taxpayer during that period, and it is not a deductible item.

The lower court, in permitting such an obligation to be deducted as interest, allowed the tax-

payer to have a deduction for essentially the same items which were properly deducted by the predecessor company in a prior year. Moreover, treatment of the payment as interest permitted the taxpayer, contrary to correct principles of tax accounting, to deduct two years' interest in one year.

II

Even if the taxpayer's obligation to pay the predated "interest" could possibly be viewed as being deductible interest, the lower court, nevertheless, erred in permitting the taxpayer to deduct the full amount in one year. At the most, such an obligation would represent a prepayment of interest which must be deducted ratably over the entire life of the indebtedness, not in one year.

III

The Commissioner properly determined the amount of the taxpayer's net loss in 1940 which could be carried over as a deduction to the taxable year 1942. The deficiency determination for 1942 was timely. While assessment or collection of tax for 1940 was barred by the statute of limitations, the statute does not prevent a disallowance of a deduction claimed for 1940 where it affects the tax liability for an open year. Congress never intended that the proper amount of loss sustained in one year should be foreclosed from examination when it affects the tax liability for an open year.

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ARGUMENT

I

Interest on Indebtedness Which Is Deductible under Section 23 (b), Internal Revenue Code, Is Compensation Paid for the Use of Borrowed Funds. It Cannot Exist for a Period Which Antedates an Indebtedness. Here the Disputed Payments Were Capital Expenditures

A. *Introductory*

The problem raised by this and similar cases is whether a taxpayer can, by issuing a pre-dated obligation, purporting to bear interest during a period prior to the existence of any indebtedness, deduct as "interest" under Section 23(b) of the Internal Revenue Code sums which are in fact capital expenditures. The facts here presented show plainly that the payments sought to be deducted as interest were really capital expenditures. They certainly were not within the meaning of Section 23(b).

The interest which is deductible under the statute is compensation for the use of borrowed funds. There can be no compensation for the use of borrowed funds for a period during which no funds were borrowed. A payment which purports to be interest for a period prior to the indebtedness may —and does in this case—actually represent an additional cost incurred by the debtor in acquiring assets. Such a payment cannot be deducted as though it were interest on borrowed money. In other circumstances, it might represent a prepayment of interest or a discount of the obligation

which, for tax purposes, must be amortized over the entire life of the indebtedness. Whatever else it may be, however, such a payment cannot be considered as being interest for the prior period, and, if deductible at all, it certainly cannot be deducted in full in the year when it is paid or accrued. Analysis of the facts of this case shows the applicability of the foregoing principles.

The creation of the taxpayer corporation was the culmination of proceedings under Section 77B of the Bankruptcy Act; sixty-five corporations previously constituting the Philadelphia Rapid Transit System [4] were consolidated and merged into the taxpayer.

A "Second Revised Plan of Reorganization", originally proposed in 1937 and twice amended in 1938, was finally approved and confirmed by the district court on November 14, 1939. (R. 5, 39-80.) The "effective date" of this plan was to be January 1, 1939. Under its terms, the public holders of stock, or of stock-trust certificates, in certain lessor companies were to receive from the taxpayer, in satisfaction of their claims, a cash payment and securities of the new company, consisting of shares of participating preferred stock and of 3-6 percent "consolidated mortgage bonds," varying in amount according to the value of their interests in

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[4] These included the Philadelphia Rapid Transit Company, 27 lessor companies, and 37 companies whose stock was wholly owned either by Philadelphia Rapid Transit Company or by the lessor companies. (R. 4-5, 65-66.)

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the old companies. (R. 5-6, 49-50, 72.) Consolidated mortgage bonds were also to be distributed to the bondholders of two of the lessor lines, viz., the holders of Darby, Media and Chester Street Railway Company (Darby) 4½ percent first mortgage bonds, and holders of Doylestown and Willow Grove Railway Company (Doylestown) first mortgage 4 percent bonds. (R. 6, 52.) Other bondholders of the lessor lines were to receive new first and refunding 4 percent mortgage bonds issued by the taxpayer. (R. 51.) Other interest-bearing obligations of the predecessor companies were not to be affected by the reorganization plan, but were to remain outstanding and to be assumed by the taxpayer. (R. 48, 59-61, 73, 74-77.)

The controversy here arises with respect to the 3-6 percent consolidated mortgage bonds. "Fixed" interest of 3 percent was payable semi-annually on these bonds in any event; an additional contingent "income" interest, not to exceed 3%, was payable to the extent to which net income in any year was sufficient. (R. 47-48, 81-82; Ex. 7-G, pp. 71-73.) Coupons for the fixed and contingent interest were to be attached to the bonds. The bonds were to be dated January 1, 1939, the effective date of the plan, and were to mature on January 1, 2039. (R. 46-48, 81-89.)

On January 29, 1940, less than a month after it came into existence, the taxpayer executed and delivered $32,529,943.54 face amount of these consolidated mortgage bonds to the mortgage trustee

for authentication and distribution to the persons entitled to receive them. (R. 7-8.) The trustee in turn delivered $31,933,543 face amount of these bonds to the holders of stock and stock trust certificates in the lessor lines, and $596,400 face amount to the bondholders of the Darby and Doylestown lines. (R. 5-6, 9.) Simultaneously, the taxpayer delivered to the trustee its check for $966,952.30, representing the amount due on the fixed interest coupons for 1939. (R. 9-10.) Both coupons for the 1939 fixed interest were attached to the bonds delivered to the former stockholders in the lessor lines (R. 9), but, pursuant to an order of the court, the fixed interest coupons for the first half of 1939 had been detached before delivery from the bonds delivered to the Doylestown and Darby bondholders. (R. 6-7, Ex. Q, pp. 10685-10686.) Accordingly, the trustee distributed to the former group $958,006.30, representing the "fixed interest" for all of 1939, and to the Darby and Doylestown bondholders the remaining $8,946, representing "fixed interest" for the latter half of 1939. (R. 9.)

The apparent reason why the bankruptcy court ordered these fixed interest coupons detached from the bonds delivered to the old bondholders of the Darby and of the Doylestown lines is that each received, in 1939, the semi-annual interest on their old bonds, the payment, apparently, being made by the old company during the course of the receivership. In the case of the Darby line, the interest paid was due on July 1, 1939. (R. 6-7.)

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In the case of the Doylestown line, the interest was due on June 1, 1939 (R. 6), and these bondholders, by order of the bankruptcy court, received an additional cash payment of $500 from the taxpayer on January 29, 1940, representing 3 percent of the face amount of their new bonds for the period June 1, 1939, to July 1, 1939 (R. 6; Ex. Q, p. 10685).

The taxpayer, in addition, on June 28, 1940, delivered to the trustee its check in the amount of $819,754.58 for payment to the consolidated mortgage bondholders in satisfaction of the contingent interest coupons with respect to income earned by the predecessor company during 1939. This was in accordance with a report made to the taxpayer showing that the income earned during 1939 by the predecessor, the Philadelphia Rapid Transit Company, permitted a payment at the rate of 2.52 percent on the taxpayer's outstanding consolidated mortgage bonds. In computing the earnings of the Philadelphia Rapid Transit Company, this report disregarded the rentals payable in 1939 to the lessor lines (which, of course, had not been paid) and took no account of an interim cash payment which was made to certain lessor companies pursuant to an order of the bankruptcy court. (R. 10-11.)

The balance sheet with which the taxpayer opened its books in the late Spring of 1940, effective as of January 1, 1940, showed under "matured interest" an item which included the $966,952.30 obligation for the 1939 fixed interest coupons, and

also included the $500, previously mentioned, which was paid to the bondholders of the Doylestown line. (R. 8-9.) The taxpayer's books also showed under "accrued interest" an item of $820,225.18 representing the obligation to redeem the 1939 contingent interest coupons on these bonds, of which as already noted, $819,754.58 was ultimately paid. (R. 10.)

In its income tax return for 1940, the taxpayer, which reported its income and deductions on the accrual basis, claimed a deduction with respect to the consolidated bonds in the amount of $1,787,206.88, consisting of $966,952.30 and $500 which was paid on January 29, 1940, and of $819,754.58 which was paid on June 28, 1940, as described above. (R. 12; Ex. 10-J, Schedule 12.) Whether these items are properly deductible is the ultimate question for decision.[5]

During 1940, the taxpayer also accrued items for the two fixed interest coupons and for the contingent interest coupons for that year on the consolidated mortgage bonds. These items, aggregating $1,944,845.18, were also claimed as a deduction under the heading of "interest" in the taxpayer's 1940 return. The Commissioner has not questioned the correctness of this deduction. (R. 11-12; Ex. 10-J, Schedule 1, p. 3.)

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[5] The taxable year involved in these proceedings is 1942, where the taxpayer claimed a net operating loss deduction which was carried over from 1940. The ultimate issue involves the proper computation of the net operating loss in 1940 which may be carried over under Sections 23 (a) and 122, Internal Revenue Code (Appendix, *infra*).

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B. *The disputed payments represent a portion of the cost of property acquired by the taxpayer rather than deductible interest on an indebtedness*

Section 23 (b) of the Internal Revenue Code (Appendix, *infra*), provides for the deduction of "all interest paid or accrued within the taxable year on indebtedness * * *." The meaning of this section is clear. Deductible interest comprehends only those payments which are "compensation for the use or forbearance of money" (*Deputy* v. *DuPont*, 308 U. S. 488, 498); it is "the amount which one has contracted to pay for the use of borrowed money". *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 560. Accord: *Equitable Society* v. *Commissioner*, 321 U. S. 560, 564.

In the instant case no compensation was paid for the use or forbearance of money when the taxpayer, simultaneously with the execution and delivery of its bonds on January 29, 1940, purported to pay a full year's fixed interest for 1939.[6] Prior to the issuance of the bonds, the taxpayer was indebted to no one. Prior to that time, the taxpayer did not have the use or forbearance of anyone's money. The payment of $966,952.30 on January 29, 1940, could not possibly represent compensation for the taxpayer's use of borrowed money in 1939. Con-

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[6] As already noted, pp. 10-11, *supra*, only a half year's fixed interest and an additional $500 was paid on $596,400, face amount, of those bonds, which were delivered to bondholders of the Darby and Doylestown lines.

sequently, the liability which the taxpayer had listed on its opening books (effective even before the bonds had been issued) as "matured interest," could not be deductible, accrued interest, as that term is employed in the statute. The same observations are true with respect to the contingent interest for 1939, liability for which was accrued on the taxpayer's opening books for 1940, and payment of which was made on June 29, 1940. Here, too, the taxpayer was not compensating anyone for the use of funds which it borrowed in 1939.

It is not questioned that these were obligations which the taxpayer assumed on its organization; undoubtedly, they properly appeared as liabilities on its opening books. But they were not obligations for accrued interest deductible under Section 23 (b). They represented, instead, part of the obligations undertaken by the taxpayer in order to acquire the assets of the old companies. These payments were as much a part of the cost to the taxpayer of obtaining those assets as were the other cash payments which it made and the securities which it issued to effectuate the plan of reorganization. Such was the position taken by the dissenting judge below. (R. 99-100.)

Commissioner v. *Drovers Journal Pub. Co.*, 135 F. 2d 276 (C. A. 7), is persuasive that the taxpayer's obligation to redeem the 1939 coupons was not a liability for deductible interest. There, a subsidiary corporation issued its own securities, including interest bearing notes, to acquire the out-

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standing capital stock of the parent company. The notes were issued on December 7, 1937, but were dated January 1, 1937. Reversing the Tax Court, the Court of Appeals held that interest could not be deducted on the notes for the period which antedated their issue, saying (p. 279):

> It is certain that no interest can be paid for the use of money if there is no use of the money, and since no indebtedness was owing by the respondent to the preferred stockholders of Corn Belt Publishers, Inc., prior to December 7, 1937, the $28,000 could not be paid as compensation for pre-December 7 use of the $400,000 borrowed on the notes.

The courts have repeatedly struck down such attempts to claim as deductible interest payments which were actually part of the purchase price of acquired assets. *F. A. Gillespie & Sons Co.* v. *Commissioner*, 154 F. 2d 913 (C. A. 10), certiorari denied, 329 U. S. 781; *Rodney, Inc.* v. *Commissioner*, 145 F. 2d 692 (C. A. 2); *Hundahl* v. *Commissioner*, 118 F. 2d 349 (C. A. 5); *Autenreith* v. *Commissioner*, 115 F. 2d 856 (C. A. 3); *Commissioner* v. *Lincoln-Boyle Ice Co.*, 93 F. 2d 26 (C. A. 7); *Baltimore & O. R. Co.* v. *Commissioner*, 78 F. 2d 460 (C. A. 4); *Henrietta Mills* v. *Commissioner*, 52 F. 2d 931 (C. A. 4); *Daniel Bros. Co.* v. *Commissioner*, 28 F. 2d 761 (C. A. 5); *Pratt-Mallory Co.* v. *United States*, 12 F. Supp. 1020 (C. Cls.); *Medical Bldg. of Houston* v. *Commissioner*, decided November 10, 1943 (1943 P-H B. T. A. Memorandum Decisions,

par. 43,478). Cf. *Magruder* v. *Supplee,* 316 U. S. 394. See also *Lloyd* v. *Commissioner,* 154 F. 2d 643 (C. A. 3), certiorari denied, 329 U. S. 717.

To the extent that a contrary result was reached in *Commissioner* v. *Pressed Steel Car Co.,* 152 F. 2d 280 (C. A. 3); *Commissioner* v. *Columbia River P. Mills,* 126 F. 2d 1009 (C. A. 9); *Ernst Kern Co.* v. *Commissioner,* 1 T. C. 249; and *Oregon Pulp & Paper Co.* v. *Commissioner,* 47 B. T. A. 772, petition for review dismissed November 2, 1943, the decisions are demonstrably in error. An analysis of those cases will reveal that in each the interest which was permitted to be deducted with respect to a period which antedated the indebtedness should have been considered as an added cost of the assets acquired.

In the present case, it is impossible to escape the conclusion that when the taxpayer redeemed the 1939 coupons it was, in part, satisfying claims against the predecessor companies, thereby making one of the expenditures which enabled it to acquire the assets of those companies. This is fully apparent from a consideration of the reorganization plan. By selecting an effective date for the plan (and for the bonds) which was not dependent on the actual date of consummation, the plan of reorganization imposed an obligation on the taxpayer which was not different from that which it assumed when it obligated itself to distribute more than $2,200,000 in cash to the majority of persons who were entitled

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to acquire these bonds.[7] Certainly, there could be no contention that the latter liability accrued as a deductible item when the taxpayer came into being as a corporation; on the contrary, it is overwhelmingly plain that this was one of the costs of the taxpayer's acquiring the assets of these lessor companies and of satisfying the value of their claims in the bankruptcy proceedings. It was a capital expenditure, not a deductible expense.

If the effective date of the plan had been set to coincide with the date of consummation, and if, just prior to going into effect, the plan had been revised to provide that an additional amount of cash should be distributed by the new company to these security holders, there similarly could be no valid contention that the additional cash was deductible. This, too, would clearly be one of the costs incurred by the new company in acquiring the assets of the old companies. Yet the establishment of an effective date of a reorganization plan which, instead of coinciding with the date of consummation, will probably antedate it, and of issuing interest bearing securities dated as of the effective date, is essentially a method of providing that additional cash shall be distributed to the security holders in the event that the plan cannot be carried into effect until after the effective date has passed. While not a permissible method of decreasing the

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[7] The bondholders of the Darby and of the Doylestown lines received only new consolidated mortgage bonds, and did not share in the cash contribution.

tax liability of the new company, it is a sensible procedure, designed to maintain a fair and equitable scheme of distribution where litigation or other obstacles might prevent timely execution of the plan. It is a recognized and accepted technique in reorganization proceedings. See *Ecker* v. *Western Pacific R. Corp.*, 318 U. S. 448, 509-510; *Group of Investors* v. *Milwaukee R. Co.*, 318 U. S. 523, 529, 546; *R. F. C.* v. *Denver & R. G. W. Co.*, 328 U. S. 495, 521.

By approving and confirming the plan here, the District Court must have considered that it made adequate provision for the various security holders in the companies which were being reorganized, and that it recognized the relative priority of the claimants in accordance with the doctrine of *Northern Pacific Ry. Co.* v. *Boyd*, 228 U. S. 482; *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106; and *Consolidated Rock Co.* v. *DuBois*, 312 U. S. 510. The proponents, in drafting the plan, and the bankruptcy court, in evaluating it, could not know when the plan would eventually go into effect. This, of course, is true of most reorganization proceedings. If the plan did not provide for an effective date, and if the interest bearing securities were not to be issued as of that effective date, it is quite plain that any delay might require later revisions in the allocation of cash and securities in order to maintain the relative priority of the various claimants. Otherwise, the earnings of the company during the interval might ultimately inure to the primary

benefit of claimants having a lower order of priority, namely, the new common stockholders, and the plan would fail to recognize that the claims of senior security holders against the debtor have been augmented by the further passage of time during the continued course of the reorganization proceedings. By giving the plan an effective date, however, this can usually be avoided, for the bankruptcy court can consider whether the plan is fair and equitable as of the effective date, and the creditors having the highest priority, and entitled to the highest ranking securities (first mortgage bonds) in the new company, will receive additional cash payments, under the title of predated interest, the amounts payable being dependent on the length of time that elapses after the effective date. Even as between senior and junior bondholders, the selection of an effective date will help in maintaining the relative priority of their claims, dependent upon the interest rates established in the new senior and junior mortgage bonds.

In the present case, for example, of the various security holders affected by the reorganization, bondholders in several of the lessor companies had the face amount of their old bonds satisfied, dollar for dollar, by the issuance of new first mortgage bonds, bearing 4 per cent interest. This was evidently considered a complete satisfaction of their claims. (R. 51.) The claims of the stockholders of lessor lines were obviously considered inferior, for they were satisfied, in part, by the consolidated

mortgage bonds, which were junior to the first mortgage bonds (R. 46), and in part by preferred stock and a comparatively small amount of cash.[8] Moreover, the former stockholders of the old Transit Company received only common stock in the new corporation. (R. 50.) As between these groups, it is clear that the junior security holder ought not to obtain a better position by the passing of time, as would be true if the first mortgage bondholders were to receive nothing additional, and if the interim earnings could be accumulated to pay dividends on the new stock. Such disturbance of the relative priority of the claimants caused by the passage of time could be avoided by a last minute change in the plan, just prior to consummation, to provide for a new cash adjustment. It can also be avoided, normally, and more conveniently, by giving the plan a definite, effective date which will antedate the time when it is actually carried into effect.

What we emphasize is that these additional cash payments, even though spoken of as "interest" from the effective date of the plan to the time when consummated, are truly a part of the price paid by the new company to obtain the assets of the companies which were being reorganized. They do

---

[8] The claims of the bondholders of the Darby and the Doylestown lines were evidently considered inferior to these, for they received only a portion of the face amount of their old bonds in consolidated mortgage bonds; they received no preferred stock and did not participate in the cash distribution provided for in the plan.

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not, for tax purposes at least, differ from the other cash payments scheduled to be made under the reorganization plan, simply because, as a matter of convenience in calculation and payment, they are denominated "interest." They are not, and cannot be, interest on borrowed funds for, until the plan was consummated, the taxpayer was not indebted to these security holders. Indeed, the stockholders of the lessor lines who received the majority of the consolidated mortgage bonds did not previously have an interest bearing claim, even as against the old companies. Their claim in reorganization was based only upon unpaid rentals owing from the old Transit Company and the value of their rights in the property to be acquired by the new company.

In this connection, it should be observed that the earnings of the predecessor company in 1939, as stated in the report which formed the basis for the computation of the amount owing by the taxpayer on the 1939 contingent "interest" coupons, showed a gross income of $5,836,729.49, and deductions (other than interest) of $2,549,616.09, leaving $3,287,113.40 available for fixed and contingent interest. Interest of $1,406,621.03 for 1939 was owing on bonds and other obligations of predecessor companies which were not affected by the reorganization but which were still outstanding and were assumed by the taxpayer. (R. 48, 59-61, 73, 74-77; Ex. 9-I.) The record is not clear whether this amount of interest was paid by the predecessor

in 1939, or by the taxpayer in 1940. At all events, *the operations of the predecessor in 1939 enhanced the receivership estate by a net amount of $1,880,492.43.* It is significant that $1,862,330 is the approximate amount of interest, both fixed and contingent, which the taxpayer paid for 1939 on its own first mortgage and consolidated mortgage bonds. This plainly demonstrates that what the taxpayer paid as 1939 "interest" was really the cost of the assets added to the receivership estate by the 1939 operations of the predecessor.

It would seem that the bankruptcy court also viewed the 1939 coupons as being part of the cost of satisfying creditors' claims and of acquiring the assets of the debtor companies. Nothing else will explain the treatment of the bondholders of the Darby and Doylestown lines. These bondholders, as has already been observed, p. 10, *supra,* had received a semi-annual interest payment on their old bonds during the reorganization proceedings in 1939. Although the plan itself had made no such provision, in the order confirming the plan the bankruptcy court required that one semi-annual, fixed interest coupon be detached from the new bonds delivered to these bondholders, and that a cash payment of $500 be made to the bondholders of the Doylestown line to adjust for one month's interest on the new bonds. Quite plainly, it was believed that a portion of their claims against the debtor companies had been satisfied by the interest payment received in 1939 and, accordingly, that

what the taxpayer was obligated to pay to receive the mortgaged assets should be proportionately reduced.

It is likewise significant that the Pennsylvania Public Service Commission did not view these disputed payments as being the kind of interest which should be deducted in determining the taxpayer's earnings for 1940 since, in accordance with the Commission's regulations, they were not permitted to be deducted as expenses in the taxpayer's accounts. (R. 11.)

C. *The lower court's decision is wrong in permitting essentially the same deduction to be taken successively by both the old company and the new company.*

That the Court of Appeals here reached the wrong conclusion is also evident from the anomalous results which its decision requires in this and similar situations. One such anomaly is that it permits essentially the same deduction to be taken in successive years by different taxpayers. Thus, in its tax return for 1939, the predecessor company accrued its liability for a full year's interest on the mortgage bonds of the Darby and Doylestown lines. (Resp. Ex. R, Schedule 1, p. 5.) Although it had actually paid only a half year's interest on those bonds, it was entitled to deduct the full amount of the accrued liability since it, too, was on the accrual basis. It also accrued and deducted its liability for the full amount of the

unpaid rentals due to the various lessor lines in 1939. (Resp. Ex. R, Schedule 1, p. 7 and Schedule 1A.) We believe that this was also a proper deduction. I.T. 3635, 1944 Cum. Bull. 101.[9]

If the court below is correct, and if the taxpayer is also entitled to accrue as deductible interest the amount of its liability on the 1939 coupons to the old stockholders of the lessor lines (in lieu of 1939 rentals) and to the old mortgage bondholders of the Darby and the Doylestown lines (for 1939 interest), it is plain that a double, successive deduction has been allowed with respect to what is essentially the same liability. A similar opportunity for double deductions would arise whenever there is a reorganization and where the accrual method of accounting is employed. Yet, it is familiar law that the revenue acts should be construed so as not to permit double deductions. *McLaughlin* v. *Pacific Lumber Co.*, 293 U. S. 351, 355-356; *Ilfeld Co.* v. *Hernandez*, 292 U. S. 62, 68; *United States* v. *Ludey*, 274 U. S. 295, 301.

The court below thought it significant that "neither the present taxpayer nor any of its predecessors was in a position to take advantage of a 1939 deduction for the interest payments in question." (R. 99.) What it failed to observe, however, is that the predecessor company was in

[9] While an Internal Revenue Agent proposed to disallow the accrual of the rentals for 1939, it does not appear that his recommendations were ever acted on by the Commissioner. (R. 15-16.) I.T. 3635, *supra*, would indicate that his recommendations were wrong in this respect.

a position to take, and did take, a deduction for its rental and interest obligations—the same obligations which were satisfied, whether in whole or in part, by the taxpayer's 1939 coupons. The fortuitous circumstances that the predecessor company had no net taxable income in 1939 is of no consequence, for it is quite possible that other predecessor corporations in such circumstances might have net income and double tax benefits would be possible as a result of such double, successive deductions.

D. *The error in treating the 1939 coupons as "interest" is further demonstrated by the fact that the taxpayer was allowed to accrue interest deductions for two years in one year—a result that is inconsistent with the accrual system of accounting*

Another anomalous result of the lower court's treatment of the disputed payments as interest is that the taxpayer is permitted to accrue the liability for two years' interest in one year. Thus, in its tax return for 1940, the taxpayer accrued the full amount of its liability for the 1940 fixed and contingent interest coupons on the consolidated mortgage bonds. (R. 11-12; Ex. 10-J, Schedule 1, p. 3.) To permit the taxpayer, however, as the decision below does, also to accrue in 1940 what purports to be an interest liability for 1939 offends a basic principle of tax accounting.

Interest is a liability which accrues ratably

with the passage of time. It accrues as a liability, not when payment is made, but during the period of the borrowing for which the payment is to be made. The basic principles in this respect were stated with unusual clarity in *Miller & Vidor Lumber Co.* v. *Commissioner,* 39 F. 2d 890, 892 (C.A. 5), certiorari denied, 282 U. S. 864:

> Each year's interest was ratably earned by the use of the principal sum in the business of the taxpayer during the year of its use. It was an expense of creating the income for each separate year, and the net income of the business for a particular year could be ascertained only by deducting from gross income the item of annual interest. The year of the payment of the interest and the year when the interest matured have no importance, where the accounting is on the accrual basis. Scientific accounting requires the deduction to be made from the gross income, which the item of expense helped to create, and that requires the deduction for annual interest to be made from the gross income of the year in which the principal served to create it.

Accord: *Warner Co.* v. *Commissioner,* 11 T.C. 419, 431; *B. F. Goodrich Co.* v. *Commissioner,* 1 T.C. 1098, 1101; *Higginbotham-Bailey-Logan Co.* v. *Commissioner,* 8 B.T.A. 566, 577; *McIntosh & Seymour Corp.* v. *Commissioner,* 2 B.T.A. 953, 956-957.

Under correct principles of accounting it is impossible, accordingly, that interest for more than one year can be accrued in one year when the

liability is not in dispute. Net income on an annual basis could not be clearly reflected by an accounting method which permitted such an aggregation of deductions. See Section 43, Internal Revenue Code (Appendix, *infra*); Section 19.43-2, Treasury Regulations 103 (Appendix, *infra*).

The taxpayer, moreover, was not even consistent in the manner in which it treated these items in its 1940 tax return, for, while it deducted the accrued liability for both the 1939 and 1940 coupons on the consolidated mortgage bonds, it did not assert a similar, double deduction with respect to the interest on the first mortgage bonds; instead, it only deducted the accrued liability for the 1940 interest on those bonds. (R. 29; Ex. 10-J, Schedule 1, p. 3.)[10] We submit that the taxpayer was correct in claiming a deduction for a single year's interest on the first mortgage bonds, but was wrong in claiming a deduction for two years' interest on the consolidated mortgage bonds.

The court below attempted to answer this by drawing an analogy between the situation here and one where the interest coupons for the first year "were just double the later ones in amount." (R. 98.) Apart from the obvious fact that the 1939 "interest" was never intended as compensation for the use of borrowed money during the first year

[10] The taxpayer deducted $75,123.82 as interest in 1940 on the first mortgage bonds. This represents one year's interest of 4 percent on approximately $1,897,860, face amount of these bonds, authorized to be issued and outstanding by the reorganization plan. (R. 51.)

(1940), the court's assumption that in the supposed situation the "double" amount would be fully deductible merely begs the question. If part of the "double" amount truly represents part of the purchase price, as we submit is the case here, it does not become transmuted into deductible interest simply because the parties have described the obligation as though it were interest. *Autenreith* v. *Commissioner*, 115 F. 2d 856, 858 (C. A. 3); *Pratt-Mallory Co.*, v. *United States*, 12 F. Supp. 1020, 1021 (C. Cls.). See *Magruder* v. *Supplee*, 316 U. S. 394, 399. The tax result cannot be changed because the parties chose to evidence two separate obligations by a single coupon. Further, if part of the "double" amount, instead of representing a portion of the purchase price, constituted a prepayment of interest for the entire period (see point II, *infra*, pp. 28-29), the obligor would not be relieved of the necessity of amortizing this over the life of the obligation by the simple expedient of pretending that a "double" rate of interest is payable for the first year.

II

If the Liability for the Disputed Payments Represents Interest, It Is a Prepayment of Interest Which Must Be Accrued Ratably Over the Life of the Indebtedness

We believe that the position developed in point I —that the amounts in question do not represent deductible interest—is the only permissible one. If we are mistaken, and if the 1939 "interest"

coupons truly represented an obligation to pay compensation for the use of borrowed funds, the decision below would, nevertheless, still be wrong in permitting the entire liability to be accrued and deducted in one year.

It has already been adequately demonstrated that the taxpayer did not and could not have an obligation to pay compensation for funds borrowed in 1939, since the taxpayer's indebtedness did not exist until the bonds were issued in 1940. If the taxpayer's obligation with respect to the 1939 coupons did actually represent compensation for the use of borrowed funds, it could only represent compensation for future use. The most that it would constitute, then, would be a partial prepayment of interest, similar to the issuance of bonds at a discount. As such, it would be deductible, not in one year, but ratably over the entire period of the obligation, in this case during a period of 99 years. *Helvering* v. *Union Pacific Co.*, 293 U. S. 282; Section 19.22(a)-18(3) (a), Treasury Regulations 103 (Appendix, *infra*). A prepayment of interest, like other prepaid expenses, cannot be deducted in full in the year of payment, but must be apportioned over the entire period covered by the expenditure. *Security Mills Co.* v. *Commissioner*, 321 U. S. 281, 285-286; *Commissioner* v. *Boylston Market Ass'n*, 131 F. 2d 966 (C. A. 1), and cases there cited at page 968. This, it should be noted, is as applicable to taxpayers who use the cash dis-

bursements and receipts method of accounting, as it is to those who employ the accrual method.

III

In Making a Timely Deficiency Determination for 1942, the Commissioner Was Not Barred from Ascertaining the Correct Amount of the Taxpayer's Net Loss in 1940 Which Could Be Carried Over to 1942

In the lower courts, the taxpayer contended that, regardless of whether it was actually entitled to these deductions for 1940, they could not be questioned in this case because of the statute of limitations. Neither the Tax Court nor the Court of Appeals found it necessary to pass on this argument.

The taxable year involved in these proceedings is 1942. It is not disputed that the Commissioner's deficiency determination for that year was timely. The proper amount of interest which may be deducted by the taxpayer for 1940 is involved only because the taxpayer is asserting a net operating loss deduction in 1942 under Section 23 (s) of the Internal Revenue Code (Appendix, *infra*), which it seeks as a carry-over from 1940, pursuant to Section 122 of the Internal Revenue Code (Appendix, *infra*). The taxpayer's argument seems to be that, since the Commissioner did not disallow the deduction for interest which it claimed in its 1940 return prior to the expiration of the three year statute of limitations, that deduction was "allowed by this chapter," as that term is used by Section 122 (a) in defining "net operating loss." The taxpayer

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contends that this construction is supported by *Virginian Hotel Co.* v. *Helvering*, 319 U. S. 523. Accordingly, so it is argued, the amount of the loss carry-over from 1940 which can be deducted in 1942 cannot be questioned by the Commissioner, even though 1942 is still an open year.

1. A short answer to this contention is that the statute of limitations (Section 275 (a), Internal Revenue Code (Appendix, *infra*)) provides only that taxes shall be assessed within three years and that no court proceedings for collection without assessment shall be instituted after that time. The Commissioner is not, however, attempting to assess or collect any tax liability for 1940, which is all that the statute forbids. He has (R. 13) "disallowed" the asserted deduction for 1940 only to the extent that it affects the proper tax liability for 1942.[11] There is nothing in Section 275 (a) or in any other section to prevent such a disallowance. See *Commissioner* v. *Disston*, 325 U. S. 442, 449, where the Court, speaking of the similar statute of limitations applicable to the gift tax, said that it—

> simply prevents assessment and collection of a tax for a year barred by the statute. The statute does not purport to preclude an examination into events of prior years for the purpose of correctly determining gift tax liability for years which are still open. * * *

[11] Apart from the question of limitations, the Commissioner was certainly not disabled from reopening the 1940 returns for the purpose of disallowing a deduction which he had previously approved. This question was set at rest a number of years ago. *Burnet* v. *Porter*, 283 U.S. 230.

Accordingly, even if the taxpayer's construction of Section 122 were correct, the ultimate conclusion which it urges would be without foundation since the Commissioner has, in fact, properly disallowed these items. Cf. *Lord Forres* v. *Commissioner*, 25 B. T. A. 154; *Mitchell* v. *Commissioner*, 27 B. T. A. 645; *Alabama Mineral Land Co.* v. *Commissioner*, 28 B. T. A. 586.[12]

2. Moreover, it seems clear from the context of Section 122(a) that the word "allowed" refers merely to deductions that are legally permissible under the statute, and not to administrative action in approving or failing to disapprove a deduction claimed by a taxpayer. Consequently, the *Virginian Hotel* case, relied upon by respondent, can have no application here.

---

[12] Section 272 (g) of the Internal Revenue Code (26 U.S.C. 1946 ed., Sec. 272), empowers the Tax Court, in redetermining a deficiency for a particular year, to "consider such facts with relation to the taxes for other taxable years as may be necessary correctly to redetermine the amount of such deficiency," though the Tax Court has no jurisdiction to determine whether the tax for such other years has been overpaid or underpaid.

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CONCLUSION

The decision of the Court of Appeals should be reversed.

Respectfully submitted,

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NOVEMBER, 1949.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness * * *.

* * * * *

(s) [as added by Section 211 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862.] *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U.S.C. 1946 ed., Sec. 43.)

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SEC. 122 [as added by Section 211 (b) of the Revenue Act of 1939, *supra*]. NET OPERATING LOSS DEDUCTIONS.

(a) [as amended by Section 105 (e)(3)(A) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) [as amended by Section 153 (a) of the Revenue Act of 1942, *supra*] *Amount of Carry-Back and Carry-Over.*—

* * * * *

(2) *Net Operating Loss Carry-Over.*—If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the intervening taxable year * * *.

* * * * *

(26 U.S.C. 1946 ed., Sec. 122.)

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

(a) *General Rule.*—The amount of income taxes imposed by this chapter shall be assessed within three years after the return

was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

* * * * *

(26 U. S. C. 1946 Ed., Sec. 275.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22(a)-18. *Sale and purchase by corporation of its bonds.*—

* * * * *

(3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *

* * * * *

SEC. 19.43-2. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. * * *

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No. 126

IN THE

Supreme Court of the United States

October Term, 1948

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

PHILADELPHIA TRANSPORTATION COMPANY

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 872

Commissioner of Internal Revenue, Petitioner

v.

Philadelphia Transportation Company.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

OPINIONS BELOW.

The opinion of the Tax Court (R. 17-37) is reported at 9 T. C. 1018. The opinion of the Court of Appeals (R. 97-100) is reported at 174 F. 2d 255.

JURISDICTION.

The judgment of the Court of Appeals was entered on March 21, 1949 (R.101). The petition for a writ of certiorari was filed on June 16, 1949. The jurisdiction of this Court is invoked under Title 28 U. S. C., Section 1254(1).

QUESTIONS PRESENTED.

1. Where an accrual basis taxpayer upon incorporation in 1940 issued its bonds dated January 1, 1939, pursuant to a plan of reorganization under Section 77B of the Bankruptcy Act, are amounts paid in 1940 to redeem interest coupons for 1939 deductible in 1940 as accrued interest under the Internal Revenue Code?

2. Where the Commissioner of Internal Revenue does not disallow a deduction claimed on a taxpayer's federal income tax return within the statutory period for assessing additional income tax, may he thereafter, upon examination of the taxpayer's return for a later taxable year, disallow the deduction and reduce the loss carried forward to such later year under the Internal Revenue Code?

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations involved may be found in the Appendix, *infra*, pp. .

STATEMENT.

The Philadelphia Rapid Transit Company, a Pennsylvania Corporation (one of Respondent's predecessors), operated a street railway system in Philadelphia under long-term leases. In 1934 it filed a voluntary petition under Section 77B of the Bankruptcy Act (R. 19). Thereafter two plans of reorganization were filed, but because of objection of interested parties, neither was approved by the Court. Finally, a third plan known as the Second Revised Plan was filed on December 1, 1937, and amended on June 1, 1938, and November 15, 1938. This Plan was approved by the Court on November 14, 1939 (R. 19, 39).

It provided for the consolidation and merger of sixty-

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five of the corporations previously constituting the Philadelphia Rapid Transit Company system, and pursuant thereto an Agreement of Consolidation and Merger was adopted by these corporations (R. 22). The Plan and Agreement provided that Respondent, Philadelphia Transportation Company, a new corporation (who will be referred to in this Brief as the taxpayer) would result from the merger and consolidation of the old companies (R. 22). It also provided that the taxpayer would issue its Consolidated Mortgage Bonds to holders of stock and stock trust certificates of certain of the merging companies in exchange for their stock which would be cancelled in the merger and consolidation (R. 20; Exhibit 6-F, R. 81). In addition the Plan required the taxpayer to issue certain Consolidated Mortgage Bonds to holders of First Mortgage Bonds of two of the merging companies in exchange for their old bonds (R. 20, 21).

Pursuant to the Plan and the Agreement of Consolidation and Merger the taxpayer was incorporated on January 1, 1940 (R. 25). As required by the Plan of Reorganization, the taxpayer on January 29, 1940, issued its Consolidated Mortgage Bonds which were dated January 1, 1939 (R. 25). When the taxpayer opened its books as of January 1, 1940, it set up as a liability the interest due for 1939 in accordance with the provisions of the bonds (R. 27, 28). On January 29, 1940, and June 28, 1940, the taxpayer redeemed the interest coupons for 1939 (R. 29, 30).

In its Federal income tax return for the calendar year 1940 the taxpayer claimed a deduction for this interest paid in 1940 as interest accrued in 1940 (R. 32). The taxpayer had a loss for the calendar year 1940 which it carried over to the calendar year 1942 as a net operating loss deduction in accordance with the provisions of the Internal Revenue Code (R. 32). Petitioner disallowed the deduction for accrued interest in computing the net operating loss for 1940 to be carried over to 1942 (R. 32).

The period for assessment of additional tax with respect to the year 1940 expired not later than August 15, 1944 (R. 32). Petitioner examined the taxpayer's return for the year 1940 and advised it on January 19, 1943, that he would accept the return as filed (R. 34). Thereafter, no redetermination of the taxpayer's liability was made until the deficiency notice in this proceeding was mailed on October 8, 1945. In both the Tax Court and the Court of Appeals the taxpayer contended, in the alternative, that petitioner was obliged to recognize the deduction claimed because he did not challenge it in time. In view of their decision for the taxpayer on the first question, neither the Tax Court nor the Court of Appeals passed upon this alternative contention.

ARGUMENT.

1. This case involves the deduction of interest under Section 23(b) of the Internal Revenue Code.[1] This section permits a taxpayer to deduct all interest paid or accrued within the taxable year on indebtedness except interest incurred or continued to purchase or carry tax free obligations.

The requirements of the Statute are clearly met in this case.[2] The bonds constitute indebtedness. This no one challenges. Likewise the payments in question constituted interest. The amounts were paid as interest pursuant to the plan of reorganization (R. 48), pursuant to the consolidated mortgage bonds themselves (R. 81), and pursuant to the coupons in redemption of which the pay-

[1] Appendix, *infra*, p. 15.

[2] The requirement of payment and the statutory exception are eliminated from consideration in this case because the taxpayer is on the accrual basis and it was stipulated that the indebtedness involved was not incurred or continued for the excepted purpose (R. 3, 14).

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ments were made (R. 88, 89). The payments constituted the price of borrowed money and were clearly interest as that term is understood in the business community. Indeed, the petitioner himself, in a ruling issued to the taxpayer, held that the payments were interest (R. 90). Finally, the interest accrued in 1940, the year in which the taxpayer came into existence and issued its bonds (R. 7).

2. Petitioner urges conflict between the present case and *Commissioner* v. *Drovers Journal Publishing Co.*[3] as a reason for granting the writ in this case. While the decisions appear to be in conflict, the taxpayer submits that the decision in the *Drovers Journal* case, decided in 1943 and never followed, was wrong because it was based upon unsound grounds. The Court of Appeals for the Seventh Circuit did not believe that its decision in the *Drovers Journal* case was contrary to that of the Court of Appeals for the Ninth Circuit in the earlier case of *Commissioner v. Columbia River Paper Mills*[4] where a similar interest deduction was allowed. The Seventh Circuit thought the two cases were distinguishable and it is at this point that the Court fell into error.

It sought to distinguish the *Columbia River* case on the ground that the taxpayer in that case had exchanged its bonds for its own preferred stock, on which there were dividend arrearages. Thus, according to the Seventh Circuit, no new indebtedness was created upon the issuance of the bonds because they merely refinanced a pre-existing indebtedness, whereas in the *Drovers Journal* case the capital notes were not issued for a pre-existing indebtedness of the taxpayer.

This distinction which the Court of Appeals attempted to make finds no support in the facts, because the *Colum-*

[3] 135 F. 2d 276 (7th Cir. 1943), reversing B. T. A. memo. dec., CCH Dec. 12,521-C.

[4] 126 F. 2d 1009 (9th Cir. 1942), affirming 43 B. T. A. 104.

bia River notes were not issued to finance a pre-existing indebtedness.[5]

The seeming conflict between the present case and the *Drovers Journal* case stems not so much from a contrariety of view as to the interpretation of Section 23(b) of the Internal Revenue Code as from an erroneous application of certain basic principles of corporate law in the *Drovers Journal* case.

The *Drovers Journal* case has uniformly been regarded as unsound and has not been followed by any court. Indeed, the petitioner himself has apparently had some misgivings about the case because, having had ample opportunity heretofore to seek this Court's decision, he has instead acquiesced in the Tax Court's adverse decision in one case,[6] agreed to a dismissal of his petition for review by the Court of Appeals in another,[7] and failed to seek a writ of certiorari in two cases, one of which was decided by the same circuit which decided the present case.[8]

3. Petitioner contends that "some of the '1939 interest' plainly amounted to a payment by the taxpayer of the obligations of its predecessor companies—*i. e.*, obligations which it had assumed as part of the purchase price of their assets,"[9] because, according to the peti-

[5] The preferred stock dividend arrearages did not constitute an indebtedness of the corporation. It is well settled that undeclared dividends, even though cumulative and in arrears, do not give rise to a debtor-creditor relationship between the corporation and its shareholders. See 11 FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, § 5321 (Perm. ed. 1932).

[6] *The Ernst Kern Co.*, 1 T. C. 249 (1942), A. 1944 CUM. BULL. 16.

[7] *Oregon Pulp & Paper Co.*, 47 B. T. A. 772, petition for review dismissed on the authority of *Commissioner* v. *Columbia River Paper Mills, supra*, on stipulation of the Commissioner (9th Cir., November 2, 1943).

[8] *Commissioner* v. *Columbia River Paper Mills, supra*, and *Commissioner* v. *Pressed Steel Car Co.*, 152 F. 2d 280 (3rd Cir. 1945), affirming per curiam T. C. memo. dec., CCH Dec. 14,100(M).

[9] In framing his statement of the question presented (Pet. 2) petitioner says that the taxpayer's bonds were issued in exchange for assets. The bonds were not in fact so issued. They were issued to security holders of the predecessor companies in connection with the 77B reorganization of the taxpayer and were not issued in exchange for assets (R. 20).

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tioner, the taxpayer could not properly have paid the 1939 income interest as its own obligation since it had no income and "so would have been precluded from paying such interest by the terms of the reorganization plan."[10] On the contrary, the taxpayer was *required* by the terms of the plan of reorganization to pay the 1939 interest as *its own obligation* because the plan provided that upon confirmation the reorganization should "become effective as of *January 1, 1939*" (R. 64).[11]

Petitioner also argues that the removal of certain fixed interest coupons from some of the new bonds issued in exchange for old bonds of predecessor companies indicates that the taxpayer treated the interest as paid in discharge of a pre-existing liability assumed in the reorganization.[12] The removal of the coupons was required by the order of the reorganization court[13] and the fact that some security holders, pursuant to the plan of reorganization, received less interest than others in no way demonstrates that the interest was part of the costs of the assets acquired.

Although the petitioner finds an anomaly in treating the 1939 payments as interest and says it can be resolved only by treating them as part of the cost of assets, the taxpayer submits that the anomaly lies in treating the payments as anything other than interest. Entirely apart from the interest payments under consideration, cash in excess of $2,200,000 was paid to the exchanging security holders of the taxpayer's predecessors in accordance with the plan of reorganization (R. 52). If some payment in addition to the $2,200,000 had been contemplated under the plan, it would have been anomalous to have made it indirectly in interest coupons rather than directly as a

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[10] Pet. 6.

[11] The amount of income interest in question was determined on the basis of the income for 1939 reconstructed to give effect to the plan of reorganization as of January 1, 1939 (R. 30).

[12] Pet. 6.

[13] Exhibit Q, Order No. 901.

further cash payment. The reorganization court would not have countenanced such a subterfuge.

Contrary to the petitioner's assertion, the interest in question was not paid "in discharge of the liabilities, accrued before the consolidation and merger, of [the taxpayer's] predecessor companies".[14] No obligation to discharge any pre-existing liabilities was imposed upon the taxpayer by the plan of reorganization. When the taxpayer paid the interest in question it was paying interest on its own obligation newly created in 1940 and not on the obligation of a third party. The taxpayer did not assume an existing liability on which interest had already accrued and consequently the interest paid by the taxpayer was clearly not part of the cost of the assets.

Petitioner himself has previously held that the payments in question constituted interest and not part of the cost of the assets. In advising the taxpayer that it was required to withhold income tax on payments made to nonresident alien bond holders, petitioner ruled that: "The distribution under consideration in the instant case is held to *represent a payment of interest on an outstanding obligation*" (R. 91). (Emphasis supplied.)

Petitioner suggests[15] that this case involves "the propriety of the deduction by a taxpayer on the accrual basis of 'interest' for two years in a single year". While he makes no reference to them, petitioner includes Section 43 of the Internal Revenue Code and Section 19.43-2 of Regulations 103 in his Appendix and it is these authorities upon which petitioner presumably relies in claiming that there is here an improper "double" interest deduction. The taxpayer submits that the Code and the Regulations, instead of supporting the petitioner's view, in fact support the taxpayer's position. Section 43 provides that deductions "shall be taken for the taxable year in which 'paid or accrued' * * * unless in order to clearly

[14] Pet. 6.

[15] Pet. 3, fn. 2.

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reflect the income the deductions or credits should be taken as of a different period * * *".[16]

Under this section the interest was deductible in 1940 because it accrued in 1940. It would have been improper to deduct it in any other year. That some other interest also accrued in the same year in no way changes this conclusion. Nor do the accounting requirements of the Public Utility Commission of Pennsylvania have any significance in this case.[17] The accounting requirements of the Commission are designed to supply statistical data in aid of regulation and rate making. Furthermore, the requirements of federal or state regulatory bodies are not determinative of Federal tax liability.[18]

Based upon the argument that some part, if not all, of the sum in question was paid in discharge of liabilities of taxpayer's predecessors accrued before the consolidation and merger, petitioner sees a conflict between the decision in this case and *Rodney, Inc.* v. *Commissioner*.[19] The deduction disallowed in the *Rodney* case was interest

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[16] Compare *Security Flour Mills Co.* v. *Commissioner*, 321 U. S. 281 (1944), in which this Court observed (at pp. 286, 287) that "the uniform result [of the application of Section 43] has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount." The Court observed (at pp. 285, 286) that the exception in Section 43 "was not intended to upset the well-understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer."

In *Dixie Pine Products Co.* v. *Commissioner*, 320 U. S. 516 (1944), this Court again said (at p. 519) that it "has never been questioned that a taxpayer who accounts on the accrual basis may, and should, deduct from gross income a liability which really accrues in the taxable year."

[17] See Pet. 6, fn. 3.

[18] *Old Colony Railroad Co.* v. *Commissioner*, 284 U. S. 552 (1932); *East Penn Transportation Co.*, 6 T. C. M. 1097 (1947).

[19] 145 F. 2d 692 (2d Cir. 1944).

on a predecessor's bonds which accrued prior to the date of liquidation and assumption of liability by the taxpayer. As was pointed out above, no part of the interest in the present case was paid in discharge of the liability of a third party or of the taxpayer accruing before the consolidation and merger. Thus there is no conflict with the *Rodney* case. Actually, the two cases are in accord rather than in conflict because the interest which accrued from the date the taxpayer assumed its predecessor's obligation in the *Rodney* case, was allowed as a deduction, being interest on the taxpayer's own indebtedness. Similarly in the present case the interest in question was interest on the taxpayer's own indebtedness, and hence was properly deductible.

4. Petitioner suggests that *Pratt-Mallory Co.* v. *United States*[20] "seems also to be in conflict with the instant case."[21] *Pratt-Mallory* is clearly distinguishable because it obviously turned on the peculiar facts involved. There, through a series of errors commencing when the taxpayer mistakenly reported another's income as its own, the taxpayer finally reached the position where it was endeavoring to deduct the same item twice. The Commissioner, adopting an equally untenable position, sought to deny any deduction at all. The Court of Claims, quite properly it would seem, held that the taxpayer was entitled to deduct the item once, and only once. It will be observed that the *Pratt-Mallory* case was decided prior to any of the cases which involved the precise question here being considered. Presumably it was not thought to be in point in those cases and, indeed, in the present case both the Tax Court and the Court of Appeals expressly said it was not (R. 36, 99, fn. 4).

5. It should be observed that in cases such as the present the Federal revenues are amply protected by

[20] 12 F. Supp. 1020 (Ct. Cl. 1936).

[21] Pet. 5.

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statute. The Secretary of the Treasury is given the right under Chapter X of the Bankruptcy Act to object to a plan of reorganization which has for one of its principal purposes the avoidance of taxes,[22] and if the reorganization judge is satisfied that a tax avoidance purpose exists, he must refuse to confirm the plan. The Secretary participated in the reorganization in the present case. He would most certainly have objected to confirmation if he had thought, as petitioner now does, that security holders in the predecessor companies were to receive, in addition to the cash payment exceeding $2,200,000 as provided in the plan, a further cash payment disguised as interest solely in order that taxpayer might reap a tax benefit.

We believe that petitioner has mistakenly overestimated the practical importance of the present question in the administration of the Internal Revenue Code. He has apparently overlooked the powers already conferred upon the Secretary of the Treasury by the Congress in the enactment of amendments to the Bankruptcy Act.

6. Entirely apart from the question of the deductibility of the interest on the merits, the decision of the Court of Appeals was in fact correct for a reason not stated by the Court. The interest deduction in question was once allowed by the petitioner and he therefore cannot now disallow it after the period for assessment of additional tax for 1940 has expired.[23]

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[22] Section 266 of the Act (11 U. S. C. § 666) provides that the Secretary shall be informed of reorganization proceedings and Section 269 (11 U. S. C. § 669) authorizes him to appear and object to the confirmation of any plan which involves tax avoidance. Such objection is required to be heard and determined independently of any other objections which may be made to the confirmation of the plan.

[23] Because their decision was for the taxpayer on the first point neither the Tax Court nor the Court of Appeals discussed this alternative contention which was pressed by the taxpayer in both Courts. Nor did the dissenting judge in the Court of Appeals discuss this argument although a discussion of the second point would appear to be necessary to a complete disposition of the case in view of his opinion against the taxpayer on the first point.

Section 122(a)[24] of the Code defines the net operating loss which may be carried over from one year to another as the "excess of the deductions allowed by this Chapter over the gross income, with the exceptions, additions and limitations provided in subsection (d)."[25] Under this statutory definition it follows that if the deductions claimed by the taxpayer on its 1940 return have been "allowed" within the meaning of Section 122(a), the Commissioner erred in disregarding them in determining the taxpayer's income tax liability for 1942.

The meaning of the word "allowed" as used in a substantially identical section of the Internal Revenue Code[26] has already been defined by this Court. In *Virginian Hotel Corporation of Lynchburg* v. *Commissioner*[27] this Court defined the meaning of the word "allowed" as follows:

> "* * * 'allowed' connotes a grant. Under our federal tax system there is no machinery for formal allowances of deductions from gross income. Deductions stand if the Commissioner takes no steps to challenge them. Income tax returns entail numerous deductions. If the deductions are not challenged, they certainly are 'allowed', since tax liability is then determined on the basis of the returns. Apart from

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[24] Appendix, *infra*, p. 15.

[25] The "exceptions, additions and limitations provided in subsection (d)" are not applicable to this case.

[26] Section 113(b)(1)(B), which was involved in the *Virginian Hotel* case provides:

"(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

"(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent *allowed* (but not less than the amount allowable) *under this chapter* or prior income tax laws. * * *." (Emphasis supplied.)

Section 122(a) involved in the present case provides:

"Definition of Net Operating Loss. As used in this section, the term 'net operating loss' means the excess of the deductions *allowed by this chapter* over the gross income, with the exceptions, additions, and limitations provided in subsection (d)." (Emphasis supplied.)

[27] 319 U. S. 523 (1943).

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contested cases, that is indeed the only way in which deductions are 'allowed'."[28]

Under this definition of the word "allowed" it follows that all deductions, including the interest deduction in question, claimed by the taxpayer on its 1940 return were "allowed" within the meaning of Section 122(a) of the Code. Petitioner accepted the taxpayer's return for 1940 as filed, advising the taxpayer of that fact, and did not make any change in it prior to the expiration of the statutory period for doing so (R. 32). Petitioner was, therefore, obliged by Section 122(a) to recognize such deductions in computing the taxpayer's net operating loss for 1942. His present attempt to disallow them came too late.

CONCLUSION.

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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Attorneys for Respondent.

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[28] 319 U. S. at p. 527.

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APPENDIX.

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

SEC. 122. NET OPERATING LOSS DEDUCTION.

(a) DEFINITION OF NET OPERATING LOSS.—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

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No. 126

IN THE

Supreme Court of the United States

OCTOBER TERM, 1949

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

PHILADELPHIA TRANSPORTATION COMPANY

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF FOR THE RESPONDENT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1949. No. 126.

Commissioner of Internal Revenue, Petitioner

v.

Philadelphia Transportation Company.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR THE RESPONDENT.

OPINIONS BELOW.

The opinion of the Tax Court (R. 17-37) is reported at 9 T. C. 1018. The opinion of the Court of Appeals (R. 97-100) is reported at 174 F. 2d 255.

JURISDICTION.

The judgment of the Court of Appeals was entered on March 21, 1949 (R. 101). A petition for a writ of certiorari was filed on June 16, 1949, and was granted on October 10, 1949. The jurisdiction of this Court is conferred by Title 28 U. S. C., Section 1254(1).

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QUESTIONS PRESENTED.

1. Where an accrual basis taxpayer upon incorporation in 1940 issued its mortgage bonds dated January 1, 1939, and maturing January 1, 2039, in compliance with a plan of reorganization approved by the District Court under Section 77B of the Bankruptcy Act, are amounts paid in 1940 to redeem interest coupons for 1939 deductible in 1940 as accrued interest under the Internal Revenue Code?

2. Where the Commissioner of Internal Revenue does not disallow a deduction claimed on a taxpayer's federal income tax return within the statutory period for assessing additional income tax, may he thereafter, upon examination of the taxpayer's return for a later taxable year, disallow the deduction and reduce the loss carried forward to such later year under the Internal Revenue Code?

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations involved may be found in the Appendix, *infra,* pp. 33 and 34.

STATEMENT OF THE CASE.

QUESTION 1.

The Philadelphia Rapid Transit Company (one of Respondent's predecessors) operated a street railway system in Philadelphia under long-term leases. In 1934 it filed a voluntary petition under Section 77B of the Bankruptcy Act (R. 19). Thereafter two plans of reorganization were filed, but because of objection of interested parties, neither was approved by the Court. Finally a third plan known as the Second Revised Plan was filed on

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December 1, 1937, and amended on June 1, 1938, and November 15, 1938. This Plan was approved by the Court on November 14, 1939 (R. 19, 39).

It provided for the consolidation and merger of sixty-five of the corporations previously constituting the Philadelphia Rapid Transit Company system, and pursuant thereto an Agreement of Consolidation and Merger was adopted by these corporations (R. 22). The Plan and Agreement provided that Respondent, Philadelphia Transportation Company, a new corporation (which will be referred to in this Brief as the taxpayer) would result from the merger and consolidation of the old companies (R. 22). It also provided that the taxpayer would issue its Consolidated Mortgage Bonds, dated and bearing interest from January 1, 1939 and maturing January 1, 2039, to holders of stock and stock trust certificates of certain of the merging companies in exchange for their stock which would be cancelled in the merger and consolidation (R. 20; Exhibit 3-C, R. 41; Exhibit 6-F, R. 81). In addition the plan required the taxpayer to issue a relatively small amount of Consolidated Mortgage Bonds to holders of First Mortgage Bonds of two of the merging companies in exchange for their old bonds (R. 20, 21).

Pursuant to the Plan and the Agreement of Consolidation and Merger the taxpayer was incorporated on January 1, 1940 (R. 25). As required by the Plan of Reorganization, the taxpayer on January 29, 1940, issued its Consolidated Mortgage Bonds which were dated January 1, 1939 (R. 25). When the taxpayer opened its books as of January 1, 1940, it set up as a liability the interest due on the 1939 coupons in accordance with the provisions of the bonds (R. 27, 28). On January 29, 1940, and June 28, 1940, the taxpayer redeemed these interest coupons (R. 29, 30).

By letter dated September 23, 1940, the petitioner (who will be referred to in this Brief as the Commis-

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sioner) ruled that the payments on the 1939 interest coupons were "interest on an outstanding obligation", and accordingly instructed the taxpayer that ownership certificates were required and that it should withhold income tax in the case of nonresident alien bondholders (R. 32; Exhibit 15, R. 90).

In its Federal income tax return for the calendar year 1940 the taxpayer claimed a deduction for this interest paid in 1940 as interest accrued in 1940 (R. 32). The taxpayer had a loss for the calendar year 1940 which it carried over to the calendar year 1942 as a net operating loss deduction in accordance with the provisions of the Internal Revenue Code (R. 32). The Commissioner disallowed the deduction for accrued interest in computing the net operating loss for 1940 to be carried over to 1942 (R. 32).

QUESTION 2.

The period for assessment of additional tax with respect to the year 1940 expired not later than August 15, 1944 (R. 32). The Commissioner examined the taxpayer's return for the year 1940 and advised it on January 19, 1943, that he would accept the return as filed (R. 34). Thereafter, no redetermination of the taxpayer's liability was made until the deficiency notice in this proceeding was mailed on October 8, 1945.

In both the Tax Court and the Court of Appeals the taxpayer contended, in the alternative, that the Commissioner was obliged to recognize the deduction claimed because the deduction was allowed within the meaning of Section 122 of the Code since the Commissioner had failed to challenge it in time. In view of their decision for the taxpayer on the first question, neither the Tax Court nor the Court of Appeals passed upon this alternative contention.

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SUMMARY OF ARGUMENT.

I.

The payments in question constituted interest as that term is commonly understood in the business community. The interest accrued during the taxable year on the taxpayer's indebtedness. The payments thus precisely meet the requirements of the Internal Revenue Code and are, therefore, deductible.

II.

The Commissioner allowed the deduction of the payments in question. He did not thereafter move to disallow them within the statutory period granted him to do so. Having allowed the deduction for the year in which it was taken on the taxpayer's return, the Commissioner is required by the Internal Revenue Code to recognize the deduction in computing the taxpayer's net operating loss to be carried over to a subsequent year. The present attempt to disallow the deduction comes too late.

ARGUMENT.

I. The Amounts Paid by the Taxpayer in Redemption of Interest Coupons for 1939 on Its Consolidated Mortgage Bonds Constituted Interest on Indebtedness Which Accrued in 1940 and Which was Therefore Deductible From Gross Income for that Year.

The Commissioner has challenged the taxpayer's right to a deduction under Section 23(b) of the Internal Revenue Code. This section permits a taxpayer to deduct all interest paid or accrued within the taxable year on indebtedness.[1]

[1] Section 23(b) excepts interest on indebtedness incurred or continued to purchase or carry tax free interest obligations. This exception and the requirement of payment are eliminated from consideration in this case because it was stipulated that the indebtedness involved was not incurred or continued for the excepted purpose and the taxpayer is on the accrual basis (R. 14, 3).

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Section 23(b) requires the taxpayer to show onl that:

1. The Consolidated Mortgage Bonds constitute i debtedness,

2. The payments which the taxpayer made const tuted interest, and

3. Such interest accrued in 1940.

The Tax Court and the Court of Appeals held tha the payments in this case satisfied the requirements Section 23(b) and were, therefore, properly deducted b the taxpayer. This conclusion is in accord with all th decided cases on the subject save one.[2]

1. *Indebtedness.*

The Commissioner apparently recognizes that th taxpayer's Consolidated Mortgage Bonds constitute i debtedness. The bonds were validly issued (R. 25); the represent the taxpayer's unconditional obligation to pa a fixed sum at a specified maturity date;[3] and they a secured by a mortgage on all the taxpayer's propert subject only to the encumbrances of certain enumerate prior liens (R. 26). The bonds unquestionably const tute indebtedness of the taxpayer.

2. *Interest.*

The facts in this case conclusively show that th payments in question constituted interest and hen satisfied the second requirement of the statute. The pla of reorganization (R. 48), the bonds themselves (R. 81 and the coupons in redemption of which the payment were made (R. 88), all required the payment of th amounts as interest.

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[2] See pp. 8-13, *infra.*

[3] See Exhibit 6-F (Form of Consolidated Mortgage Bond and Coupons R. 81.

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Interest has been defined by this Court as: "the amount which one has contracted to pay for the use of borrowed money • • • In the common understanding 'interest' means what is usually called interest by those who pay and those who receive the amount so denominated in bond and coupon."[4] It is manifest from the facts in this case that this is precisely what the payments were. Plainly they were amounts paid for the use of borrowed money as that term is understood in the business community.

It is immaterial that the indebtedness was not outstanding during the interest period. Likewise, neither the rate nor the amount of interest accrued during the taxable year is material. The statute imposes no such limitations.[5]

That the payments were uniformly regarded as interest is perhaps most strikingly evidenced by the fact that the Commissioner himself held that they were interest. In advising the taxpayer that it was required to withhold income tax on payments made to nonresident alien bondholders, the Commissioner said:

> "The distribution under consideration in the instant case is held to represent a payment of interest on an outstanding obligation" (R. 91).

It is difficult to understand the reason for the Commissioner's present contention to the contrary. The facts have not changed any since he issued his ruling. If the payments were interest then, as the Commissioner said they were, they are now. It is impossible to perceive what change could take place in the nature of the payments at the moment when they passed from the taxpayer's hands into the hands of the bondholders that would cause them to assume a character different in the hands of the latter

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[4] *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 560-561.

[5] *The Ernst Kern Co.*, 1 T. C. 249 (1942), Acq. on present issue, 1944 C. B. 16; *Commissioner* v. *Pressed Steel Car Co.*, 152 F. 2d 280 (C. A. 3, 1945), affirming T. C. Memo Dec., CCH Dec. 14,100 (M).

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than in the hands of the taxpayer. Manifestly the payments were what all parties, including the Commissioner, recognized them to be—interest, both to the taxpayer as payor and to the bondholders as recipients. The Commissioner has not shown that he refunded any tax paid on the interest by the bondholders who received it.

3. *Accrual.*

The third requirement of Section 23(b) relates to accrual within the taxable year 1940. This requirement is obviously met. The taxpayer did not come into existence until 1940. Therefore, its interest obligation could not have accrued before then. "Inherent in the accrual of an obligation is the existence of an obligor."[6] The obligation to pay the interest in this case could not arise before the taxpayer came into existence and undertook to pay it. This occurred in 1940. Since the taxpayer "did not come into existence until 1940, did not issue its bonds until 1940, did not exchange them with the depositing security-holders in the reorganization proceedings until 1940, and did not actually undertake any liability until all these things had taken place, it was impossible for the interest to accrue prior to 1940".[7] Any other conclusion is a plain contradiction in terms. When these events occurred, the interest accrued.

The foregoing conclusions are fully supported by the cases which, with one exception not since followed, have uniformly held that such payments constitute deductible interest.

This question first arose in *Commissioner* v. *Columbia River Paper Mills.*[8] In this case the taxpayer had preferred stock outstanding on which there were dividend arrearages. On August 1, 1937, the taxpayer offered to exchange income bonds bearing interest from July 1, 1937,

[6] Opinion of the Tax Court (R. 37).

[7] Opinion of the Tax Court (R. 37).

[8] 126 F. (2d) 1009 (C. A. 9, 1942), affirming 43 B. T. A. 104.

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for its preferred stock. About half of the preferred stockholders accepted the offer and exchanged their stock for bonds. The taxpayer, which kept its books of account and filed its tax returns on the accrual basis, deducted in its tax return for 1937 accrued interest for the full six months from July 1, 1937 to December 31, 1937, upon the outstanding bonds so exchanged. The Commissioner disallowed the deduction to the extent that it represented interest for the period prior to the date when the bonds were issued, contending that interest upon the bonds for the period prior to their issuance was not deductible, since it constituted an addition to the purchase price paid for the stock.

The Board of Tax Appeals held that the taxpayer was entitled to deduct the interest for the full six months' period and was affirmed by the Circuit Court of Appeals for the Ninth Circuit. The Circuit Court said:

> "• • • The situation is one where the parties to the transaction, being free to contract, have agreed on the one hand to pay, and on the other hand to accept, a definitely ascertainable sum as compensation for the use of money over a stated period of time.
>
> "There is no occasion for placing a strained construction upon the statute, or for subjecting this simple agreement to an accountant's interpretation. As said in *Old Colony Railroad Company* v. *Commissioner*, 284 U. S. 552, 561, 'we think that in the common understanding "interest" means what is usually called interest by those who pay and those who receive the amount so denominated in bond and coupon, and that the words of the Statute permit the deduction of that sum, and do not refer to some esoteric concept derived from subtle and theoretic analysis'."

In *Oregon Pulp & Paper Co.*[9] which involved facts substantially similar to those of the present case, the

[9] 47 BTA 772 (1942), petition for review dismissed (C. A. 9) November 2, 1943.

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Board again held that the taxpayer was entitled to a deduction for accrued interest. In this case the taxpayer, on December 1, 1936, adopted a plan under which it offered to exchange its income bonds dated February 1, 1936, and bearing interest from that date for outstanding preferred stock. Pursuant to the plan, the taxpayer exchanged a certain number of bonds for preferred stock between December 21 and December 31, 1936. On its 1936 tax return the taxpayer, which was on the accrual basis, claimed a deduction for accrued interest on the bonds for the full period from February 1, 1936, to the end of the year. Further exchanges were made during 1937 and the taxpayer on its 1937 return claimed a deduction for interest accrued on bonds outstanding on December 31, 1937. This included interest for the period from February 1, 1936 to December 31, 1936, as well as interest for 1937 in the case of those bonds which had been issued in 1937. The Commissioner disallowed the deductions in both years to the extent that they included amounts covering a period prior to the issuance of the bonds. The Board followed its earlier decision in *Columbia River Paper Mills, supra*, and held that the taxpayer was entitled to deduct in each year the full amount of interest claimed.

It will be noted that in the *Oregon Pulp & Paper* case the Board held that the taxpayer was entitled to deduct *in 1937* interest for the period from February 1, 1936 to December 31, 1936, on bonds issued in 1937 and also interest for 1937 on such bonds. In this respect the case is identical with the present case.

The next case which arose on this subject was *The Ernst Kern Co.*[10] In the *Kern* case the taxpayer and its affiliate had been in financial straits for several years, during which time continuous efforts were being made to readjust their finances. These efforts culminated in a plan of readjustment presented by a bondholders' committee on September 19, 1934, which, after consideration, was

[10] 1 T. C. 249 (1942), Acq. on present issue, 1944 C. B. 16.

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approved by the Michigan Public Trust Commission on October 4, 1934. The plan was consummated and became operative on February 21, 1935, and pursuant thereto readjustments were consummated on that date, effective as of August 1, 1934. One of the readjustments involved the issuance of the taxpayer's ten year 5% debentures (together with preferred and common stock) in exchange for leasehold bonds of the taxpayer's affiliate which were cancelled. These debentures were dated August 1, 1934, and bore interest from that date.

The taxpayer, whose fiscal year ended January 31, kept its books and filed its tax returns on the accrual basis. In its tax return for the fiscal year ending January 31, 1936, the taxpayer deducted accrued interest on its 5% debentures for the period from August 1, 1934 to January 31, 1935. The Commissioner disallowed this deduction on the ground that it constituted part of the purchase price of the properties acquired from the affiliate.

The Tax Court held that the debentures constituted an indebtedness of the petitioner, and the amount paid thereon for the period from August 1, 1934 to January 31, 1935, was interest within the meaning of the statute and was therefore deductible. The Court said:

> "• • • The liability [for interest] accrued on February 21, 1935, [the date the bonds were issued] and within the taxable year. The statute does not require that the indebtedness upon which interest has accrued and become a liability of the taxpayer must be outstanding during the entire interest accrual period."

It will be observed that the Tax Court held in the *Kern* case that the interest accrued on the date when the readjustments under the plan were consummated and the bonds issued. This is precisely in accord with the taxpayer's contention in the present case. Here the interest

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in question accrued in 1940 when the taxpayer came into existence and the bonds were issued.

In *Commissioner* v. *Pressed Steel Car Co.*[11] the taxpayer was incorporated on July 24, 1936, and commenced operation as a going concern on July 29, 1936. On June 13, 1934, the taxpayer's predecessor company filed a petition under Section 77B of the Bankruptcy Act. The bankruptcy proceedings culminated in a plan of reorganization which was confirmed by the District Court on July 27, 1936. This plan provided that the taxpayer should issue its debentures dated January 1, 1936, and bearing interest from that date, in exchange for the assets of the predecessor company. On July 29, 1936, the taxpayer issued its debentures pursuant to the plan. The taxpayer, which reported on the accrual basis, deducted a full year's interest on the bonds in its tax return for 1936. The Commissioner disallowed interest from January 1, 1936, until July 29, 1936, when the bonds were issued, on the grounds that it represented a part of the purchase price.

The Tax Court, in accord with its earlier decisions, held that the taxpayer was entitled to deduct interest for the entire calendar year 1936. The Court of Appeals affirmed the Tax Court in a *per curiam* opinion.

The Tax Court said:

> "The obligation was the petitioner's own and it promised to pay interest as such on its debentures from January 1, 1936. Such interest accrued when the petitioner undertook the liability to pay it. It is immaterial at what rate the interest was computed or what its aggregate amount was during 1936. The petitioner agreed to pay it and properly accrued it on its books."

The foregoing language is particularly pertinent in the present case. Just as in the *Pressed Steel Car* case so in the present case did the interest accrue when the

[11] 152 F. 2d 280 (C. A. 3, 1945), affirming T. C. Memo Dec., CCH Dec. 14, 100 (M).

taxpayer undertook the liability to pay it which, as has been pointed out, could, under no circumstances, have been earlier than January 1, 1940, when the taxpayer came into existence and was legally capable of contracting obligations.

The only decision not in full accord with all the other decided cases on this point is *Commissioner* v. *Drovers Journal Publishing Co.*[12] The taxpayer submits that to the extent that the *Drovers Journal* case reached a contrary result it is wrong in principle. Both the Tax Court and the Court of Appeals for the Third Circuit have expressly refused to follow it.[13]

Both on principle and under the decided cases, the taxpayer is clearly entitled to the deduction claimed for interest accrued in 1940 on its Consolidated Mortgage Bonds.

II. Reply to the Commissioner's Argument.

A. *The Payments in Question Were Payments of Interest and Not Part of the Purchase Price.*

The Commissioner rests his case principally upon the contention that the payments in question were not interest. This, he says, is so because interest is compensation for the use of borrowed money. The taxpayer borrowed no money in 1939. Thus the payments could not have been compensation for the use of money in 1939 and are, therefore, not interest.

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[12] 135 F. 2d 276 (C. A. 7, 1943), reversing B. T. A. Memo. Dec., CCH Dec. 12,521-C.

[13] The Tax Court refused to follow the *Drovers Journal* case in the *Pressed Steel Car* case (*supra*, p. 12), saying:

> "The respondent relies on *Commissioner* v. *Drovers Journal Publishing Co.*, 135 Fed. (2d) 276. In that case the Circuit Court of Appeals for the [Seventh] Circuit reversed our memorandum opinion which was consistent with our decisions in the above cited cases. With due respect to that Court, we reaffirm our position and hold that the interest in the sum of $216,560.98 is deductible."

In the present case the Tax Court said that "we respectfully decline to follow" the *Drovers Journal* case (R. 36). The Court of Appeals, in its opinion affirming the Tax Court, acknowledged that the *Drovers Journal* case represented a contrary holding (R. 99).

The answer to this contention is plain. The statute does not require that the sums in question be paid for the use of money in 1939.[14]

The definition of interest requires only that the sum in question be compensation for the use of money. The rate of compensation or the period for which it is paid is not part of the definition. These are simply the arithmetical means by which the amount of compensation is determined. Thus, the fact that no money was borrowed and used in 1939 does not prove that the payments were not interest. This fact is immaterial. To show that the payments were not interest the Commissioner must go further and show that they were not compensation for the use of money at any time. This he fails to do because the facts plainly show that the payments were compensation for the use of money.

The Commissioner cites a number of cases which he claims support the conclusion that the payments in the present case were part of the cost of assets and not interest.[15] An analysis of these cases shows that they were all wholly dissimilar to the present case. They involved either instances where there was no indebtedness (in some of which the payments were not even denominated or intended by the parties to be interest)[16] or

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[14] *The Ernst Kern Co.*, 1 T. C. 249 (1942), where the Tax Court said: "* * * The liability [for interest] accrued on February 21, 1935, [the date the bonds were issued] and within the taxable year. The statute does not require that the indebtedness upon which interest has accrued and become a liability of the taxpayer must be outstanding during the entire interest accrual period."

[15] Brief for Petitioner, p. 15.

[16] In fact, this group of cases supports the taxpayer's contention rather than the Commissioner's. In these cases the taxpayers contended that although the payments were not stated by the parties to be interest, they were nevertheless the "same as" interest and hence should be deductible. The courts uniformly rejected this argument of equivalence. The payments were not in fact interest; that they may have been the "same as" interest does not make them deductible. In the present case it is the Commissioner who makes the argument of equivalence. The payments here were intended to be, and were, interest. Nevertheless, the Commissioner says they were the "same as" a part of the cost of the assets and hence are non-deductible. The cases he cites afford no support for this contention.

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instances where the payments were made in satisfaction of the obligation of a third party.

It is apparent that they have no relevancy to the present case. There was a valid indebtedness. The payments were stated to be interest and were intended to be such by the parties. Such interest was not paid by the taxpayer in satisfaction of the obligation of a third party. The taxpayer was satisfying its own obligation—and only its obligation—when it paid the interest. Indeed, as the Commissioner himself concedes,[17] the equity owners who received the Consolidated Mortgage Bonds held no obligations which the taxpayer could have assumed.

The present case must be sharply distinguished from cases involving the payment of third party obligations.[18] In those cases it has uniformly been held that interest accrued on an obligation assumed by a taxpayer is not deductible because it is not interest on the taxpayer's indebtedness. The present case does not involve the assumption of a liability. The interest paid in this case was paid on the taxpayer's own indebtedness.

The Commissioner speculates that the bankruptcy court must have considered the 1939 coupons as part of the cost of acquiring the assets.[19] He purports to find support for this speculation in the treatment of the Darby and Doylestown bondholders.[20] It is plain that the dis-

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17 Brief for Petitioner, p. 21.

18 For example, *Rodney, Inc.* v. *Commissioner*, 145 F. 2d 692 (C. A. 2, 1944) and *Medical Building of Houston*, 2 T. C. M. 1001 (1943). In the same category, although not interest cases, are *Magruder* v. *Supplee*, 316 U. S. 394 (1942) and *Commissioner* v. *Lincoln-Boyle Ice Co.*, 93 F. 2d 26 (C. A. 7, 1937). All of these cases are cited at pp. 15 and 16 of the Petitioner's Brief.

19 Brief for Petitioner, p. 22.

20 The Commissioner places much emphasis on the Darby and Doylestown bonds and suggests that the treatment of the interest on these bonds (less than 2% of the whole issue), as to which a different factual situation admittedly existed, should control the disposition of the case with respect to the other 98%. The facts were fully presented to the Tax Court and the Court of Appeals but they did not discuss the Darby and Doylestown bonds separately in their opinions, presumably considering that the $8,946 fixed interest involved in the case of these bonds and the $500 adjusting item were not sufficiently important to warrant special discussion or treatment and should not be allowed to becloud the main issue of the case.

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position of the Darby and Doylestown bondholders affords no basis for such a conclusion. These bonds comprised some $596,000 out of a total of over $32,000,000 issued—less than 2%. The interest paid on them was simply an adjusting item. Furthermore, the fact that a small group of security-holders, pursuant to the plan of reorganization and the orders of the bankruptcy court carrying it into effect, received less interest from taxpayer than others, in no way demonstrates that the interest was part of the cost of assets acquired.

The Commissioner also points to the computation of income interest as evidence of the fact that such interest was "really the cost of assets added to the receivership estate by the 1939 operations of the predecessor."[21] The Commissioner bases this conclusion upon the fact that the report showed that an amount substantially equal to the interest paid remained after payment of other obligations. The report of necessity must have shown this or else an improper amount of income interest was paid. The report was the purely hypothetical reconstruction of 1939 operations made necessary by the plan to show what the results would have been if the plan of reorganization had in fact been in effect one year earlier.[22] It did not reflect the actual results of operations and hence could not show what assets were added to the receivership estate by the 1939 operations. Indeed, the actual operations during that year necessarily produced at least 37% less than the Commissioner accounts for, namely, the $700,000 payment in 1939 pursuant to court order to

[21] Brief for Petitioner, p. 22.

The Commissioner refers frequently to the "predecessor" and the "operations of the predecessor". This is inaccurate. In fact there were 65 predecessors which were merged and consolidated to form the taxpayer.

[22] R. 10, Exhibit 9-I.

stockholders of lessor companies.[23] Furthermore, when consideration is given to the Commissioner's own determination of recognized depreciation,[24] it is manifest that there was no enhancement in the receivership estate in that year.

On reason the Commissioner's argument that the payments were part of the cost of the assets and hence non-deductible is unsound. The Commissioner regards the words "cost of assets" as a sort of magic touchstone. However, it is plain that the payment of the interest coupons for 1939 could not be part of the cost of the assets if that phrase be taken to mean a condition to the acquisition of title to the assets by the taxpayer.[25] The taxpayer's title to the assets was perfected without regard to the payment of the 1939 coupons—or the coupons for any subsequent year. True, non-payment of the 1939 coupons would have constituted an actionable default and may have ultimately lead to the loss of title by the tax-

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[23] R. 30; Exhibit Q (Reorganization Record) at p. 10054.

The Commissioner also thinks it significant that the regulations of the Pennsylvania Public Utility Commission did not permit the payments to be deducted as expenses. On the contrary the accounting regulations of the Public Utility Commission, which are designed to supply statistical data in aid of regulation and rate making, have no significance here. It was long ago settled that the accounting requirements of federal or state regulatory bodies are not determinative of federal tax liability. (See, for example, *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552.)

[24] R. 16, Exhibit 12-L, p. 2.

[25] It should be observed that the Commissioner regards the $2,200,000 cash paid pursuant to the plan of reorganization as a part of the cost of the assets to *the taxpayer*. This conclusion would seem to be erroneous. The cash was a part of the receivership assets which was not to be acquired by the taxpayer, and was no different than other assets of the predecessors which, under the plan, were not taken over by the taxpayer (R. 42). This is made plain by Section 5 of the plan of reorganization which, after stating the cash payments to be made to exchanging security-holders, provided that "The *balance* of cash in the [predecessor operating company's] treasury will be turned into the treasury of [the taxpayer] and shall be applicable to its corporate purposes * * *" (R. 53, Exhibit 3-C). The taxpayer simply acted as a disbursing agent to distribute the cash in the receivership estate which was not acquired by it under the plan of reorganization.

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payer—as would default in the payment of the coupons for any other year. But the taxpayer's acquisition of the assets was not dependent upon the payment of the interest in question. If, then, the taxpayer acquired the assets without regard to the payment of the interest in question, manifestly such payment was not a part of the cost of the assets.

On the other hand, if a more general meaning is ascribed to the phrase "cost of assets", it is at once evident that the payments in question likewise do not fall within such broadened definition. The 1939 coupons are no different than those for the succeeding ninety-nine years of the bonds. The bonds, and the interest coupons affixed to them, for 1939 and later years alike, are in fact all part of the obligations imposed on the taxpayer as the price of emerging from the reorganization as a going concern. But no one suggests that this means that the interest for 1940 and later years is not deductible because part of the cost of the assets. Why then should the 1939 coupons be treated differently? The coupons are all the same and must be treated the same.

The real vice in the Commissioner's argument is that it seeks to make the determination of the question of interest turn not on the intrinsic nature of the payment in question, but rather on the motive of those responsible for establishing the liability to make the payment.[26] The law of federal income taxation is sufficiently complicated without adding this refinement. The Commissioner admits that the test of whether the payment is interest is

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[26] The function of the 1939 coupons, according to the Commissioner's speculation, was to maintain the relative priority of the claimants during the period between the date of the Plan and the date of its consummation (Brief for Petitioner, p. 20). That this cannot be so is demonstrated by the fact that the stockholders of the lessor companies received not only the full payment in redemption of their 1939 coupons, but in addition a $700,000 interim payment (R. 11) which they would not have received had the plan been consummated on January 1, 1939.

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whether it is "the amount which one has contracted to pay for the use of borrowed money",[27] but instead of looking to the contract between the taxpayer and its bondholders in order to measure the interest in question by this definition, the Commissioner, contrary to his own definition, embarks upon an inquiry as to *why* the 1939 coupons were affixed to the bonds. This is essentially the same line of reasoning as the Commissioner unsuccessfully advanced in the *Old Colony Railroad Co.* case[28] where he argued that a portion of interest which the taxpayer paid on bonds issued at a premium was not really interest but was a partial return of the premium. Hence, according to the Commissioner, only the "effective" rate of interest was deductible for tax purposes. The portion representing return of premium was not deductible because it was not interest.

This Court rejected this inquiry into the nature of the interest and the motive of the person paying it.

The Court said:

> "And as respects 'interest,' the usual import of the term is the amount which one has contracted to pay for the use of borrowed money. He who pays and he who receives payment of the stipulated amount conceives that the whole is interest. In the ordinary affairs of life no one stops for refined analysis of the nature of a premium, or considers that the periodic payment universally called 'interest' is in part something wholly distinct—that is, a return of borrowed capital. It has remained for the theory of accounting to point out this refinement. We cannot believe that Congress used the word having in mind any concept other than the usual, ordinary and everyday meaning of the term, or that it was acquainted with the accountants' phrase 'effective rate'

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[27] Brief for Petitioner, p. 13.

[28] 284 U. S. 552.

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of interest and intended that as the measure of the permitted deduction.

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"In short, we think that in the common understanding 'interest' means what is usually called interest by those who pay and those who receive the amount so denominated in bond and coupon, and that the words of the statute permit the deduction of that sum, and do not refer to some esoteric concept derived from subtle and theoretic analysis."

B. *Essentially the Same Deduction Was Not Taken Successively By Two Companies.*

The Commissioner urges that the decision of the Court of Appeals is wrong because it "permitted essentially the same deduction" to be taken twice.[29]

First, it should be pointed out that it is only the Commissioner's conclusion that the deductions are "essentially the same". The record does not show that they are. But passing this, the short answer to the Commissioner's argument is that the deduction was not twice allowed.

The Revenue Agent who examined the 1939 income tax return of Philadelphia Rapid Transit Company[30] disallowed the deduction for accrued rentals (R. 15, 16). However, the depreciation claimed by Philadelphia Rapid Transit on its return was less than the amount allowable. Upon being advised of the Revenue Agent's disallowance of the deduction for accrued rentals, the company claimed the full allowable depreciation. After the allowance of such depreciation a net loss remained even with the disallowance of the accrued rentals, and the disallowance of the Darby and Doylestown interest would not change this

[29] Brief for Petitioner, p. 23.

[30] One of the taxpayer's 65 predecessors.

result. The Commissioner, therefore, assessed no additional tax.[31]

The Commissioner suggests that the Revenue Agent was wrong in disallowing the claimed deductions and cites I. T. 3635 in support of this view.[32]

It is plain that this ruling does not support the Commissioner's conclusion. In the case there presented the plan of reorganization had not even been approved by the interested parties and there was no certainty that it would be. Accordingly, it was ruled that deduction of an item accruing under such circumstances was proper because the contingency involved was insufficient to prevent the accrual.

The present case, on the contrary, goes beyond even the question of reasonable certainty of non-payment. It was a known fact that the amounts claimed as rentals would not be paid. The plan of reorganization had been approved and was carried into effect.

The Commissioner's fear that "a similar opportunity for double deductions would arise whenever there is a reorganization"[33] is groundless. No such opportunity was present in this case. And certain it is that no tax benefit was had.

C. *The Taxpayer May Deduct Two Years' Interest in One Year Because Two Years' Interest Accrued in One Year.*

The Commissioner objects that under the holding of the Court of Appeals the taxpayer was permitted to ac-

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[31] The net income as determined by the revenue agent after disallowance of the accrued rentals (and certain other adjustments) was $1,155,152.09 (R. 16). This would have resulted in a tax deficiency of $190,558.26 (R. 15). However, it was determined by the Commissioner that $1,252,363.60 depreciation was allowable in addition to that claimed on the return. This left "a * * * net loss of $97,211.51 and no tax liability" (R. 16, Exhibit 12-L, p. 2).

[32] Brief for Petitioner, p. 24.

[33] Brief for Petitioner, p. 24.

crue the liability for two years interest in one year. This, he says, violates the rule that interest "accrues ratably with the passage of time."[34]

B. F. Goodrich Co.,[35] in which the Commissioner has acquiesced and one of the cases which the Commissioner cites as establishing the rule, is a pertinent illustration of the fact that this rule, like most rules, has its exceptions. There the taxpayer in December, 1936, called its bonds for payment on February 1, 1937. The bondholders were permitted to surrender their bonds in advance of the call date and receive immediate payment in full of principal, premium and interest to February 1, 1937. Most of the bonds were surrendered on these terms prior to the end of 1936. The Tax Court held that the taxpayer was entitled to deduct in 1936 not only the interest which accrued in the normal course in 1936 but also the interest paid in 1936 which would not have accrued until 1937 but for the earlier surrender of the bonds. The Tax Court stated:

> "The debtor-creditor relationship between the petitioner and the holders of the $10,600,000 face amount of bonds ceased in 1936, the period of the loan was terminated, and interest could not thereafter accrue in regard to that particular part of this indebtedness. *The rule that interest accrues ratably is not to be carried to the extreme of having the accrual continue after the debt has been paid and canceled.*" (Emphasis supplied.)

Just as the facts of the *Goodrich* case warranted the taxpayer there in deducting interest other than on a ratable basis, so in the case at bar the rules of tax accounting required the taxpayer to deduct the interest in

[34] Brief for Petitioner, pp. 25-26.

[35] 1 T. C. 1098 (1943), Acq. 1943 C. B. 10.

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the year in which it accrued. The Commissioner points to Section 43 of the Internal Revenue Code[36] in this connection as preventing the accrual in one year of more than a single year's interest. Precisely the contrary is true. Section 43 required the taxpayer in this case to deduct both 1939 and 1940 interest in 1940, because the interest for both years accrued in 1940.

Section 43 has no bearing upon the substantive question of *when* a liability accrues. It merely requires that deductions "shall be taken for the taxable year in which 'paid or accrued' • • • unless in order to clearly reflect the income the deductions or credits should be taken as of a different period • • •."

In *Security Flour Mills Company* v. *Commissioner*,[37] this Court said that the "uniform result [of the application of Section 43] has been denial both to government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount." The Court observed that the exception in Section 43 "was not intended to upset the well understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the government or to the taxpayer".

Under these principles the interest payments in this case were deductible in 1940 and in 1940 alone, for, as was said by the Supreme Court in *Dixie Pine Products*

[36] App., *infra*, p. 33.

[37] 321 U. S. 281 (1944).

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Co. v. Commissioner,[38] it "has never been questioned that a taxpayer who accounts on the accrual basis may, and should, deduct from gross income a liability which really accrues in the taxable year." The interest accrued in 1940 and therefore, consistent with the Internal Revenue Code, the cases and the Commissioner's own Regulations, should be deducted in 1940.[39]

That some other interest also accrued in the same year is no reason for abandoning the system of annual periods of computation which requires the deduction of expenses in the year of accrual. Here the obligation to pay the interest accrued in 1940. 1940 was, therefore, the proper year to deduct it. Congress did not intend "to substitute, whenever in the discretion of an administrative officer or tribunal such a course would seem proper, a divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system." *Security Flour Mills Company* v. *Commissioner, supra,* at page 287.

The situation resulting from compliance with Section 43 in the present case is not anomalous. Taxable income varies from accounting income.[40]. Items of income or expense of an annually recurring nature may be doubled up where on a particular set of facts the principles of income tax reporting so require. To give an example, it is permissible for a taxpayer to deduct in a single year state excise taxes covering a two year period where

[38] 320 U. S. 516 (1944).

[39] Similarly, since the interest accrued as a liability in 1940, it should be deducted in that year under the rule that "the liabilities of one year cannot be used to reduce the income of a subsequent year" (Reg. 111, Sec. 29.43-2). Under the Commissioner's Regulations it would be improper to deduct the interest in any year other than 1940.

[40] It has been said, and truly, that "good accounting practice may frequently lead to a different net income than that which is taxable under the income tax statutes." 2 Mertens, *Law of Federal Income Taxation,* p. 121.

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the liability for both years' taxes attaches in the year of deduction.[41] This situation arises where a taxing statute is given retroactive effect.

A doubling up may similarly occur where a taxpayer contests liability for such a tax. Since he cannot deduct the amount of the tax so long as he is contesting liability, it may result in his deducting several years taxes in one year if and when his liability is established.[42]

Again, where a lessor on the accrual basis receives an advance payment of rent attributable to some future period he is required to report it as income when received[43] regardless of the fact that it will result in a doubling up of rental income for that year.

The Commissioner charges the taxpayer with inconsistency in that "while it deducted the accrued liability for both the 1939 and 1940 coupons on the consolidated mortgage bonds, it did not assert a similar, double deduction with respect to the interest on the first mortgage bonds; instead it only deducted the accrued liability for the 1940 interest on those bonds."[44] Passing the immateriality of the alleged inconsistency,[45] the explanation is simple: the taxpayer did not deduct 1939 interest on the first mortgage bonds for the reason that the bonds were issued without the coupons for 1939 interest attached.[46] The taxpayer never undertook to pay 1939 interest on these bonds, with the result that there was no 1939 interest to deduct.

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41 *Van Norman Co.* v. *Welch*, 141 F. 2d 99 (C. A. 1, 1944.)

42 *Dixie Pine Products Co.* v. *Commissioner*, 320 U. S. 516 (1944).

43 *Astor Holding Co.* v. *Commissioner*, 135 F. 2d 47 (C. A. 1, 1943).

44 Brief for Petitioner, p. 27.

45 The taxpayer's failure to avail itself of a deduction to which it might or might not be entitled could not under any reasoning constitute a ground for denying it the interest deduction which it is claiming in the present case. There is no element of election involved.

46 See Exhibit Q (Reorganization Record) at p. 10685.

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D. *The Payments Were Interest, But Not Prepaid Interest.*

The Commissioner next contends that even if the interest in question was in fact "interest" within the meaning of the Internal Revenue Code, it constituted a "partial prepayment of interest" and as such had to be deducted ratably over the entire period of the obligation.[47] This contention is faulty both in its premise and in its conclusion, and it is significant that the Commissioner has not cited a single case involving interest to support it.

In the first place, there was here no prepayment of interest. It is elementary that to "prepay" interest is to pay it before it is due. Here, to the contrary, the fixed interest in question was due immediately upon issuance of the Consolidated Mortgage Bonds in January, 1940, and the income interest was due in July of the same year. If the taxpayer had neglected to pay the interest in 1940 it would have been in default on the bonds.

In a ruling[48] dealing with the proper tax treatment of prepaid interest the Commissioner states:

> "It is held that where a taxpayer keeps books of account and files Federal income tax returns on the cash receipts and disbursements basis, interest paid in advance for a period of five years constitutes an allowable deduction for Federal income tax purposes for the year in which paid, but where the accrual basis of accounting is used in reporting income, interest is deductible for the year in which the liability to pay accrues regardless of when payment is actually made."[49]

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[47] Brief for Petitioner, p. 29.

[48] I. T. 3740, 1945 C. B. 109.

[49] It should be noted that this ruling, in holding that cash basis taxpayers should deduct prepaid interest in the year of payment, is contrary to the Commissioner's assertion in his brief (p. 29) in this case that cash basis taxpayers are required to apportion prepaid interest.

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This language illustrates the fact that the application of the label "prepaid" to the interest payments in this case, even if it were proper to do so, would not improve the Commissioner's position.

The inescapable fact is that the interest was deductible in 1940 the year in which it accrued and in that year only. To quote again the words of this Court,[50] it "has never been questioned that a taxpayer who accounts on the accrual basis may, and should, deduct from gross income a liability which really accrues in the taxable year." The Commissioner's argument to the contrary runs counter to the Internal Revenue Code, to the decisions of this Court, and to his own Regulations.[51]

III. In the Alternative, the Deductions Claimed by the Taxpayer on its 1940 Income Tax Return Were Allowed by the Commissioner and He Therefore Erred in Disregarding Them in Computing the Taxpayer's Income Tax Liability for 1942.

In the alternative, the taxpayer contends that the Commissioner, having previously allowed the deduction for interest claimed on the taxpayer's 1940 income tax return,[52] cannot now disallow the deduction after the period of limitation for assessment of additional tax for 1940 has expired.[53]

The taxpayer's return for 1940 was filed on July 22, 1941, pursuant to an extension of time for filing duly

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[50] In *Dixie Pine Products Co.* v. *Commissioner*, 320 U. S. 516.

[51] See pp. 21-25, *supra*, for an extensive discussion of this point.

[52] And all other deductions claimed on the 1940 return.

[53] Because their decisions were for the taxpayer on the first point neither the Tax Court nor the Court of Appeals discussed this alternative contention which was pressed by the taxpayer in both Courts. Nor did the dissenting judge in the Court of Appeals discuss this argument although a discussion of the second point would appear to be necessary to a complete disposition of the case in view of his opinion against the taxpayer on the first point.

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granted to August 15, 1941. No extensions of the period for assessment of additional tax were filed and the period for such assessment therefore expired not later than August 15, 1944. The Commissioner advised the taxpayer on January 19, 1943, that its 1940 return was accepted as filed (R. 55) and subsequently made no redetermination of the taxpayer's income tax liability for 1940 prior to the expiration of the statutory period. In fact, the Commissioner made no change in the deductions claimed on the taxpayer's 1940 return until the deficiency notice was issued in this proceeding on October 8, 1945.

Section 122 of the Internal Revenue Code[54] permits a taxpayer to equalize his income over a period of years by means of a "net operating loss carry-over". The "net operating loss" which may be carried from one year to another is specifically defined in Section 122(a) of the Code as the "excess of the deductions allowed by this Chapter over the gross income, with the exceptions, additions and limitations provided in subsection (d).[55] Under this statutory definition it follows that, if the deductions claimed by the taxpayer on its 1940 return have been "allowed" within the meaning of Section 122(a), the Commissioner erred in disregarding them in determining the taxpayer's income tax liability for 1942.

The meaning of the word "allowed" as used in this connotation in the Internal Revenue Code has been settled by the decision of this Court in *Virginian Hotel Corporation of Lynchburg* v. *Commissioner*.[56] In the *Virginian Hotel* case, this Court defined the meaning of the word

[54] 53 Stat. 867, as amended Oct. 21, 1942, 56 Stat. 807, 844, 847, 848; 26 U. S. C. A. §122.

[55] The "exceptions, additions and limitations provided in subsection (d)" are not applicable to this case.

[56] 319 U. S. 523 (1943).

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"allowed" as used in a substantially identical section of the Code[57] as follows:

> "• • • 'allowed' connotes a grant. Under our federal tax system there is no machinery for formal allowances of deductions from gross income. Deductions stand if the Commissioner takes no steps to challenge them. Income tax returns entail numerous deductions. If the deductions are not challenged, they certainly are 'allowed' since tax liability is then determined on the basis of the returns. Apart from contested cases, that is indeed the only way in which deductions are 'allowed'."

It, therefore, follows that all deductions claimed by the taxpayer on its 1940 return were allowed within the meaning of Section 122(a) of the Code. The Commissioner accepted the taxpaye-'s income tax return as filed and did not thereafter move to disallow the deductions within the time granted him to do so. Since the deductions were not challenged they were, therefore, allowed. This Court's decision in the *Virginian Hotel* case makes this conclusion inescapable. Hence, when the Commissioner redetermined the taxpayer's 1942 tax liability, he erred in disallowing the deductions claimed by the taxpayer on its 1940 return. Those deductions had already been allowed, and the Commissioner was obliged by Section 122(a) to recognize them in computing the net operating loss of the taxpayer to be

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[57] Section 113(b)(1)(B), which was involved in the *Virginian Hotel* case provides:

"(1) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—

"(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent *allowed* (but not less than the amount allowable) *under this chapter* or prior income tax laws. • • •." (Emphasis supplied.)

Section 122(a) involved in the present case provides:

"DEFINITION OF NET OPERATING LOSS. As used in this section, the term 'net operating loss' means the excess of the deductions *allowed by this chapter* over the gross income, with the exceptions, additions, and limitations provided in subsection (d)." (Emphasis supplied.)

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deducted in 1942. His attempt to disallow them came too late.[58]

The Commissioner argues[59] that he is not attempting to assess additional tax for 1940 and he can, therefore, now disallow the deduction claimed in computing the tax for 1942. He says that Section 275 of the Code does not stand in his way. But the critical section is not 275, it is 122. And Section 122 provides that if the deduction in 1940 was allowed, the Commissioner must recognize it in computing the loss carry-over to be deducted in 1942. As has been pointed out above,[60] the deduction was allowed in 1940 because it was not then timely challenged by the Commissioner. Hence he cannot disregard it in 1942.

The Commissioner also relies on *Commissioner* v. *Disston*[61] as authority for his action in the present case. But there is a significant difference between the statutory language involved in the *Disston* case and the present case. In the *Disston* case the gift tax statute under consideration provided for the addition of prior net gifts in computing the gift tax for a subsequent year. The Court held that erroneously computed prior net gifts unchallenged by the Commissioner and now barred by the statute of limitations could be corrected in computing the gift tax for a later year. It will be observed, however, that the statute refers to the addition of prior net gifts, not prior net gifts "allowed". The two cases are, therefore, wholly dissimilar. They would be the same

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[58] The cases cited in the Commissioner's brief at p. 32 against this contention arose under the provisions of earlier Revenue Acts containing no language comparable to that which appears in Section 122(a) of the Internal Revenue Code. In addition, those cases were decided by the Board of Tax Appeals prior to the decision of this Court in the *Virginian Hotel* case.

[59] Brief for Petitioner, p. 30.

[60] *Supra*, p. 29.

[61] 325 U. S. 442 (1945).

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only if the statute in one referred to deductions "allowed" and in the other to prior net gifts "allowed".[62]

CONCLUSION.

The decision of the Court of Appeals is correct and should be affirmed.

The payments in this case were interest on indebtedness which accrued in 1940. They precisely met the requirements of Section 23(b) of the Internal Revenue Code and are, therefore, properly deductible in 1940.

In the alternative, all deductions claimed on the taxpayer's 1940 income tax return were allowed within the meaning of the Internal Revenue Code when the Commissioner accepted the taxpayer's return as filed and did not thereafter challenge the deductions within the time granted him to do so. Since the deductions were allowed, the Commissioner was obliged by Section 122(a) of the Code to recognize them in computing the taxpayer's net operating loss for 1940 to be carried over to 1942.

Respectfully submitted,

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[62] The Commissioner points to nothing in the context of Section 122(a) that suggests that the word "allowed" there used should have any different meaning than that already ascribed to it by this Court.

Section 272(g) of the Code has no bearing on the present case. Whether the deduction has been "allowed" in 1940 is one of the facts which the Tax Court must take into consideration in applying Section 122(a).

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APPENDIX.

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

SEC. 122. NET OPERATING LOSS DEDUCTIONS.

(a) *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

Treasury Regulations 111.

Sec. 29.43-2. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. • • •

No. 126. COMMISSIONER OF INTERNAL REVENUE *v.* PHILADELPHIA TRANSPORTATION CO. Certiorari, *ante*, p. 810, to the United States Court of Appeals for the Third Circuit. Argued November 18, 1949. Decided November 21, 1949. *Per Curiam:* The judgment is affirmed. MR. JUSTICE BURTON dissents. MR. JUSTICE DOUGLAS took no part in the consideration or decision of this case. *Arnold Raum* argued the cause for petitioner. With him on the brief were *Solicitor General Perlman, Assistant Attorney General Caudle, Ellis N. Slack, Lee A. Jackson* and *Hilbert P. Zarky. William R. Spofford* argued the cause for respondent. With him on the brief were *Frederic L. Ballard* and *Sherwin T. McDowell.* Reported below: 174 F. 2d 255.